82-1121
NO. ________

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

LOUISIANA PUBLIC SERVICE COMMISSION,
Petitioner

versus

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

May "automatic adjustment clauses," permitting the continuous escalation of an interstate electric tariff without any requirement of a regulatory filing, be approved by the FERC to govern the interchange of power among affiliated operating companies, where the tariff directly affects intrastate rates and may cause these rates to be excessive, no special grounds exist to support the use of the automatic adjustment clauses, and the preemption doctrine probably renders the state regulatory commissions powerless to examine or adjust these expenses in setting intrastate rates?

PARTIES TO THE PROCEEDING

The following parties were involved in this case in the proceedings before the Federal Energy Regulatory Commission or the United States Court of Appeals for the Fifth Circuit:

1. Middle South Services, Inc., a subsidiary of Middle South Utilities, Inc., as the applicant before the Federal Energy Regulatory Commission and an intervenor before the United States Court of Appeals for the Fifth Circuit.

2. The Louisiana Public Service Commission, as an intervenor before the Federal Energy Regulatory Commission and the petitioner before the United States Court of Appeals for the Fifth Circuit.

3. The Federal Energy Regulatory Commission, as the respondent before the United States Court of Appeals for the Fifth Circuit.

4. The Arkansas Public Service Commission, as an intervenor before the Federal Energy Regulatory Commission.

5. The attorney general of the State of Arkansas, as an intervenor before the Federal Energy Regulatory Commission.

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PETITION FOR A WRIT OF CERTIORARI

The Louisiana Public Service Commission, petitioner, hereby petitions the Court to issue a writ of certiorari to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit entered on October 4, 1982.

OPINION BELOW

The opinion of the court of appeals, which is reproduced in the Appendix, is reported as *Louisiana Public Service Commission v. Federal Energy Regulatory Commission*, 688 F.2d 357 (5th Cir. 1982). The opinion of the Federal

Energy Regulatory Commission is also reproduced in the Appendix and is reported as *Middle South Services, Inc.*, Opinion No. 124, Docket No. ER 79277, 16 FERC ¶61, 101 (1981).

JURISDICTIONAL GROUNDS

The decision of the United States Court of Appeals for the Fifth Circuit was entered October 4, 1982. No application for rehearing was filed. This Court has jurisdiction to review the decision of the court of appeals pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS

The following statutes, set forth in the Appendix commencing at p. A-34, are involved in this case:

16 U.S.C. §824d(d);
16 U.S.C. §824d(f).

STATEMENT OF THE CASE

1. ***Preliminary statement.***

This case presents an important issue of federal regulatory law that arises in a context involving significant potential disruption of federal-state regulatory relations. The Federal Energy Regulatory Commission ("FERC") determined in the proceeding below that the normal requirement under the Federal Power Act of notice and regulatory review of a proposed rate change in interstate power transactions could be abrogated, with the utilities permitted instead to use "automatic adjustment clauses" to change these rates

without regulatory review. No evidence, or any other showing of "good cause," was required of the utilities for the approval of this proposal, though the FERC did note that the case fell into a category in which this approach has been approved in a few past proceedings.

This decision to embark on a program of regulatory abstention has large implications for the states. The tariff at issue involves interstate transactions among affiliated corporations in which the rate charges are set by the FERC, but the costs are accounted for in intrastate retail rate cases. A state regulatory body, such as the Louisiana Public Service Commission ("Louisiana Commission"), must assess the charges incurred by an operating company to intrastate ratepayers. However, under the preemption doctrine, the state agencies may not reduce or otherwise adjust the charges, even if they are based on imprudent or abnormal costs, because the charges are assessed under a tariff bearing FERC approval. Thus, in this case, the state regulatory agencies are precluded from conducting a regulatory review under the preemption doctrine, though the FERC has chosen to largely abandon its own obligation to conduct a regulatory review of any changes in the rate.

The decision of the FERC involves an agreement for the interchange of electric power among the operating companies of the Middle South Utilities System ("MSU"). These companies include Louisiana Power & Light Co. ("LP&L"), New Orleans Public Service, Inc., Mississippi Power & Light Co. and Arkansas Power & Light Co. The order of the FERC, affirming in part and modifying in part a decision of an administrative law judge, was issued July 30, 1981.[1] The

1/ R. 2021-36, *Middle South Services, Inc.*, Opinion No. 124, 16 FERC ¶61,101 (1981); App. at A-2.

Louisiana Commission filed a petition for review of the order in the court of appeals pursuant to 16 U.S.C. §825*l* (b). The court of appeals affirmed the decision of the FERC.[2]

2. ***Operation of the MSU System Agreement.***

The MSU System Agreement is the contract under which the operating companies of the MSU System exchange power. This agreement operates as the tariff approved by the FERC. The agreement reflects the principle that all generation additions in the MSU System are planned to serve the needs of the entire system. Thus, an individual company may be assigned the responsibility to construct capability in excess of its own load and need for reserves in order to serve the needs of other companies in the System. However, the excess capability is reallocated to the "short" companies, or "equalized," pursuant to the terms of the agreement.[3]

The provisions for capability "equalization" in the agreement are designed to allow the MSU System to equalize the reserve margin ratios of all the participants. These provisions assign system capability to each operating company in proportion to the company's share of the system load.[4] A similar allocation is made of the system intertransmission investment.[5]

2/ *Louisiana Public Service Commission v. Federal Energy Regulatory Commission*, 688 F.2d 357 (5th Cir. 1982); App. at A-21.

3/ Item "B" by reference, R. 2081-2198, Serv. Sched. MSS-1.

4/ *Id.* at 7-8.

5/ *Id.* at 9.

Pursuant to the provisions for capability equalization, a portion of the plant of the "long" companies is reassigned to the "short" companies. [6] A "monthly billing charge" is assessed to each "short" company for each kilowatt of capability assigned to the company. [7] The monthly billing charge is determined by a formula reflecting the monthly fixed costs assertedly associated with the "participation unit," the generating unit which is being shared, plus an amount for operation, maintenance and overhead expenses.[8]

3. *Use of automatic adjustment clauses.*

As proposed to and approved by the FERC, nearly all the charges under the MSU System Agreement are computed using automatic adjustment clauses. Under the provisions for capability equalization, the rates are automatically adjusted for changes in investment and capital costs whenever a new generating unit becomes the participation unit or whenever there has been a change in the investment in an existing participation unit. [9] In addition, the rates are automatically adjusted for changes in the expense attributable to income taxes, other taxes, depreciation, insurance, operation and maintenance expense, and general and administrative overhead expense. [10] The only fixed charge in the approved

6/ *Id.*, Serv. Sched. MSS-1, Serv. Sched. MSS-2.

7/ *Id.*, Serv. Sched. MSS-1, ¶10.06.

8/ *Id.*, ¶10.05.

9/ *Id.*, Serv. Sched. MSS-1.

10/ *Id.*, Serv. Scheds. MSS-1, MSS-2; Item "A" by reference, R. 1113-1210, Serv. Scheds. MSS-1, MSS-2.

formula is the cost of equity, which is set at 14 per cent.[11] A similar formula approach permits the charge for transmission equalization to be automatically adjusted.[12]

Many of the automatic adjustment clauses employed in the MSU tariff were approved by the Federal Power Commission in 1973.[13] However, no objections to the clauses had been lodged, nor had hearings been held on the propriety of the formulae.[14] In its filing in this case, MSU proposed to add to the automatic adjustment clauses for operation and maintenance and general and administrative overhead expense.[15] The Louisiana Commission contested the use of any automatic adjustment clauses in the tariff and the administrative law judge ruled that an examination of the entire tariff was proper.[16] The administrative law judge ultimately approved the use of the automatic adjustment clauses, but conditioned their operation on certain filing and

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11/ Opinion No. 124, R. 2021-36, at 12; App. at A-2.

12/ Item "A" by reference, R. 1113-1210, Serv. Sched. MSS-2.

13/ Order Accepting for Filing and Suspending Proposed Interconnection Agreement, Providing for Limited Hearing, and Establishing Procedures, *Middle South Services, Inc.*, Docket No. E-8130 (F.P. C., June 29, 1973).

14/ *Id.* at 1-2.

15/ Item "A" by reference, R. 1113-1210, Serv. Scheds. MSS-1, MSS-2.

16/ R. 120-21. This ruling was consistent with prior decisions of the FERC. *See, e. g., Southern California Edison Co.*, Docket No. ER 79-150 (FERC, March 15, 1979), slip opinion at 5. ("It is the entire rate, not just the increase, which is the subject of investigation"). *See also, Central Maine Power Co.*, Docket No. ER 79-539 (FERC, Sept. 28, 1979).

reporting requirements.[17] The FERC overruled this holding and approved all of the automatic adjustment clauses without condition.[18]

The evidence before the FERC showed that the automatic adjustment clause approach resulted in the assessment of charges under the federal tariff that would have been disallowed in an ordinary rate case. For instance, prior to 1980, MSU included accumulated deferred taxes in the rate base in computing the charges under the tariff in contravention of the rules of the FERC and policy stated in at least two FERC orders.[19] Similarly, nonrecurring expenses were included in the expenses used to develop the charge in the tariff for operation and maintenance and overhead expense.[20] These actions resulted in overcharges of millions of dollars.[21]

4. *Impact of the federal tariff on intrastate ratepayers.*

Although the payments under the MSU System Agreement are established under a federally-approved tariff, they are assessed and accounted for wholly in retail or wholesale rate cases.[22] For the purpose of fixing rates, rate base, revenues and expenses were not assigned to the federal

17/ *See* Initial Decision, R. 1763-1817, at 18-19.

18/ Opinion No. 124, R. 2021-36, at 5; App. at A-2.

19/ *See* Opinion No. 124, R. 2021-36, at 13; App. at A-2.

20/ R. 292 *et seq.*

21/ *Id.*

22/ Exh. 22, Prefiled testimony of Bruce M. Louiselle, R. 1031-45, at 4-6.

jurisdiction, as would occur in a normal federal ratemaking case. Instead, the tariff operates as a mechanism for shifting costs from one state to another. To the extent that an operating company is "long," revenues would be received by the company and shown in an intrastate rate case as a revenue credit. These receipts would reduce the revenues required to be provided in the intrastate jurisdiction by the consumer.[23] For "short" companies, the cost of intrasystem transactions would be shown as expenses, increasing the intrastate revenue requirement.[24] The rates established by the state regulatory agency would have to be sufficient to cover this expense and all other prudently incurred costs. The impact of the federal tariff may be the biggest reason for a rate increase; in the most recent case in Louisiana involving LP&L, for instance, the charges under the MSU tariff accounted for more than $47 million of the intrastate rate increase of about $118 million.[25]

The effect of the tariff is to shift costs from one company to another in the MSU System. If the tariff is too high, reflecting abnormal costs, a higher than required rate of return, or other improper items, ratepayers of the "short" companies are forced to subsidize ratepayers of the "long" companies.[26] If the tariff is too low, ratepayers of the

23/ *Id.* at 4-5.

24/ *Id.* A relatively small portion of the expenses or credits would be accounted for in federal wholesale cases.

25/ *Ex Parte Louisiana Power & Light Co.*, Docket No. U-14690 (La. Pub. Serv. Comm. 1981).

26/ Exh. 22, Prefiled testimony of Bruce M. Louiselle, R. 1031-45, at 4-6.

"short" companies are subsidized.[27]

The MSU System as a whole tends to gain if the tariff is too high because of the effect of regulatory lag. If a "long" company receives excess revenues under the tariff, it is not likely to lower its intrastate rates. Its earnings may be excessive until its costs increase and force it to seek rate relief. A "short" company, on the other hand, will seek rate relief from the state agency as soon as it determines that the costs under the federal tariff will increase. In the most recent intrastate rate case of LP&L, the company *forecasted* the amount of expenses that would be incurred pursuant to the federal tariff in the test year.[28]

5. ***Decision of the FERC and the court of appeals.***

The FERC approved the formulae already embodied in the MSU tariff and also approved the new automatic adjustment clauses proposed by MSU.[29] This action allows MSU to continuously raise the rate for changes in all expenses except the cost of equity, without the requirement of any regulatory filing or review. No evidence was cited by the FERC as supporting its decision. Indeed, no evidence was submitted by MSU showing any special need for the use of the automatic adjustment clauses.

27/ *Id.*

28/ *Ex Parte Louisiana Power & Light Co.*, Docket No. U-14690 (La. Pub. Serv. Comm. 1980).

29/ *Middle South Services, Inc.*, Opinion No. 124, 16 FERC ¶61,101 (1981); App. at A-2.

The FERC made three observations as the basis for the approval of the automatic adjustment clauses. They are: 1) the tariff involves affiliates; 2) the tariff permits upward or downward adjustments of the rate as costs go up or down; 3) the costs included in the rate could be verified by an FERC audit or investigation.[30] No reasons were cited as establishing a need to depart from the normal regulatory process. The court of appeals affirmed on the basis of the observations of the FERC, without further analysis of the record.[31]

REASONS FOR GRANTING THE WRIT

This case presents an important regulatory issue, arising in the special context of federal preemption of state regulatory alternatives, that should be reviewed by this Court. The Federal Power Act and the leading authorities establish the federal regulatory policy that rate changes should be made only after a formal regulatory filing and review. Though automatic adjustment clauses may be approved in special cases, as when adjustments for fuel cost changes are made under clauses filed pursuant to detailed FERC regulations, they should not be approved in general rate cases on the bare basis of verbiage that does no more than describe the tariff. The approval of these clauses amounts to a regulatory abdication because regulatory agencies in general, and especially the FERC, are unlikely to take the initiative to investigate rate changes that occur without notification to the agency.

30/ **Opinion No. 124, R. 2021-36, at 5; App. at A-2.**

31/ ***Louisiana Public Service Commission v. Federal Energy Regulatory Commission*, 688 F.2d 357, 361 (5th Cir. 1982); App. at A-21.**

The delegation of ratemaking responsibility to the utility under automatic adjustment clauses is particularly inappropriate in this case, where the impact of rate changes is felt by intrastate ratepayers. The state regulatory commissions are prevented from disallowing or otherwise adjusting the charges assessed under the tariff because of the preemption doctrine, yet these agencies are not protected by the normal requirement of a federal ratemaking review. The federal-state tensions at play in this case provide additional content to the "good cause" requirement of the Federal Power Act, establishing that only very strong reasons should be sufficient for a waiver of the regulatory process. No sufficient basis for this action has been cited, or exists, in this case.

I. THE COURT SHOULD ISSUE THE WRIT TO DETERMINE WHETHER THE APPROVAL OF AUTOMATIC ADJUSTMENT CLAUSES IS CONSISTENT WITH FEDERAL REGULATORY LAW IN THE ABSENCE OF EVIDENCE SHOWING THAT THE NORMAL REGULATORY PROCESS IS UNWORKABLE OR ANY OTHER SPECIAL REASON TO SUPPORT THE WAIVER OF NORMAL REGULATORY REQUIREMENTS.

The Federal Power Act and the leading authorities establish that rate changes must be preceded by a regulatory filing with the FERC. This requirement may be waived by the FERC only for "good cause shown" and only when an order is issued specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.[32] This limited exception is

32/ 16 U.S.C. §824d(d).

not a general authorization for the FERC to permit the utility to change its rates, without any notice or other regulatory review, every time its costs change under an automatic formula. Moreover, the "good cause" requirement should not be satisfied by mere air-filled verbiage. Some showing of necessity to abandon the regulatory process should be required.

Under the ordinary rule in regulatory matters, the utility bears the burden of going forward and obtaining approval of a proposed rate change. This requirement includes the submission of the proposed tariff for the approval of the regulatory agency. The utility may be required to carry the burden of proving that its investment was prudently incurred and its expenses are fair and reasonable. Under principles announced by this Court in *Federal Power Commission v. Hope Natural Gas Co.*,[33] the regulatory agency has the responsibility to balance the interests of investors and consumers. The process ordinarily entails a full examination of the data submitted by the utility prior to the approval of a rate change.[34]

In contrast, the tariff approved by the FERC in this case amounts to an abandonment of the regulatory process. The rate may be changed as the result of changes in any item of cost except the rate of return on equity. These rate changes may be drastic because the tariff is based on

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33/ 320 U.S. 591, 64 S.Ct. 281 (1944).

34/ 1 A. Priest, *Principles of Public Utility Regulation* (1969) at 45-138; *South Central Bell Telephone Co. v. Louisiana Public Service Commission*, 352 So.2d 964, 968 (La. 1977).

the costs associated with the "participation" unit, or unit that is being "equalized," and this unit is the most recent generation constructed by the "long" company. Thus, when a new unit goes on line, it becomes the participation unit, and virtually all the costs on which the rate is based are changed. The utility may recompute the rate on its own, including all costs in the tariff whether or not they are normal and prudently incurred, without the requirement of any regulatory review.

This approach reflects a substantial change in regulatory attitude, because it entrusts the responsibility for protecting the public interest to the utility. As MSU conceded in its brief filed with the court of appeals, the FERC is no longer "the front-line of regulatory protection against either imprudent management decisions or irregular cost recordation."[35] Instead, MSU suggested, the public can depend on the auditors employed by MSU for protection.[36] In oral argument before the court of appeals, counsel for the FERC stated that the FERC assumes the utility will act properly, or that improprieties might be uncovered in the general, periodic audits conducted by the FERC.

This approach is inconsistent with the Federal Power Act, which establishes the general rule that no rate change may go into effect without first being submitted to the regulatory process. Section 205(d) of the Act, as amended,

35/ Brief for Intervenor Middle South Services, Inc. at 25, *Louisiana Public Service Commission v. Federal Energy Regulatory Commission*, 688 F.2d 357 (5th Cir. 1982).

36/ *Id.*

states:

> Unless the Commission otherwise orders, no change shall be made by any public utility in any such rate, charge, classification, or service, or in any rate, regulation, or contract relating thereto, except after sixty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the sixty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.[37]

The policy embodied in this law recognizes that governmental agencies have limited resources and by nature tend to react rather than act. These agencies do not frequently initiate inquiries to uncover improprieties in the absence of an outside prod. However, by placing the burden on the utility to institute the regulatory process as a prerequisite to a rate change, the law ensures a degree of protection to the public.

The policy requiring a regulatory filing prior to a rate change has been endorsed by this Court. Indeed, the Court

37/ 16 U.S.C. §824d(d).

has indicated that an agreement, even if filed as a rate schedule, may not provide for increased rates without a regulatory filing. *Sunray Mid-Continent Oil Co. v. Federal Power Commission.*[38] In *Sunray*, the Court interpreted provisions of the Natural Gas Act virtually identical to the provisions of the Federal Power Act that control this case.[39] The Court held that the FPC was not bound by the limitations of a contract in the determination of the service obligation of a utility, even if the contract has been approved. It referred to automatic adjustment clauses in illustrating the point. It said:

> For example, an independent producer may file as its rate schedule its contract of sale with a pipeline company. That contract may provide in explicit terms for an adjustment of rates at a future time - - even one foreordained in a precise amount. Yet when the adjustment is made pursuant to the contract, the adjustment is subject, as a "change" in rates, to the procedures of §§4(d) and 4(e) - - however explicit the upward adjustment was in the contract from the start.[40] [Citations omitted].

Thus, the Court concluded that federal law would not permit automatic adjustments unchecked by regulation.[41]

The policy against automatic adjustments was also applied

38/ 364 U.S. 137, 153, 80 S.Ct. 1392, 1402 (1963).

39/ 15 U.S.C. §717c(d).

40/ 364 U.S. at 152-53, 80 S.Ct. at 1401.

41/ *Id.* at 153, 80 S.Ct. at 1402.

in *Episcopal Theological Seminary v. Federal Power Commission*,[42] a case cited with approval by the Court in *Sunray*.[43] In *Episcopal Theological Seminary*, the court disapproved the use of an escalation clause in a gas case. Interpreting the sister provision to Section 205(d), it stated:

> Section 4(d) . . . requires that the public must be kept informed of the "changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect." No change may be made in a "rate" or "schedule then in force," without notice to the Commission and the public. This language is persuasive that forehanded contractual provisions cannot modify the regulatory provisions of the Act as urged by petitioners. The purpose is to advise the public of a change in the current rate.[44]

The court ruled that the "rate" is the cents per unit charge and a regulatory filing is a prerequisite to changing the rate.[45]

Although these authorities indicate that automatic adjustment clauses might never be acceptable, we recognize

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42/ 269 F.2d 228 (D.C. Cir. 1959).

43/ 364 U.S. at 153, 80 S.Ct. at 1401-02.

44/ 269 F.2d at 233.

45/ *Id.* at 235.

that they are sometimes used because of necessity. Thus, in the case of fuel costs, automatic adjustment clauses have been approved by the FERC because of fluctuations of these costs and the difficulty of determining them in advance. However, these formulae must comply with detailed regulations of the FERC adopted on a generic basis.[46] The regulations reflect a limited departure from the regulatory process adopted only after a finding of good cause.

In 1978, Congress apparently recognized that the FPC and FERC had permitted departures from the normal regulatory requirements by allowing certain automatic adjustment clauses to be included in utility rate schedules. Therefore, Congress amended the Federal Power Act and required the FERC to review these clauses to determine whether the clauses existed for costs that are not "subject to periodic fluctuations" and not "susceptible to precise determinations in rate cases prior to the time such costs are incurred."[47] The FERC was authorized to invalidate clauses that do "not result in economical purchases of fuel, electric energy, or other items. . . ."[48] These amendments give content to the "good cause" requirement of Section 205(d), establishing that departures from the normal regulatory process are justified only in the limited circumstances when this action is necessary because normal ratemaking is unworkable, and only when safeguards exist to promote efficiency and econ-

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46/ *E. g.*, 18 C.F.R. 35.14.

47/ 16 U.S.C. §824d(f) (1) (B).

48/ 16 U.S.C. §824d(f) (3) (B).

omy in the cost incurrence of the utility.[49]

In this case, no generic regulation exists to permit the automatic adjustment clauses. No evidence was submitted by MSU as a special justification for the adoption of the clauses. No review was made of special reasons justifying the waiver of the regulatory process. In a single paragraph devoted to the "good cause" issue, the FERC noted that 1) the case involves affiliates; 2) the formulae permit upward or downward adjustments in the rate; and 3) the FERC can always institute an audit or investigation to uncover improprieties.[50] This explanation is nothing more than a description of the tariff coupled with an air-filled assurance that the regulatory abdication may not be total.

First, the "affiliate" point is nothing more than an obser-

49/ A 1975 House of Representatives report on automatic adjustment fuel clauses concluded that they should be abolished except in emergencies. In addition, it found that "[a]utomatic fuel adjustment clauses threaten the basis of utility regulation to the extent that their use encourages the adoption of similar automatic adjustment clauses encompassing other key aspects of utility regulation." Subcomm. on Oversight & Investigations of the House Comm. on Interstate and Foreign Commerce, 94th Cong., 1st Sess., Report on Electric Utility Automatic Fuel Adjustment Clauses (Subcomm. Print 1975) at 3,2. Other studies have suggested that the use of automatic adjustment clauses violates due process, reduces the incentive for cost control, and runs counter to traditional principles of utility regulation. *E. g.*, M. Schmidt, Automatic Adjustment Clauses: Theory and Application (MSU Pub. Util. St. 1980) at 123-24; Craft, *Due Process Restraints on the Use of Automatic Adjustment Clauses in Utility Rate Schedules*, 18 Ariz. L. Rev. 453 (1976); Note, *Due Process and the Automatic Fuel Adjustment Clause*, 52 Ind. L. J. 637 (1977).

50/ Opinion No. 124, R. 2021-36, at 5; App. at A-2.

vation of the corporate relationship of the transacting parties. It does not by itself embody any reason to abrogate regulation. As the FERC noted, automatic adjustment clauses have been permitted in a few past cases involving affiliates,[51] but these cases do not provide reasons for departing from the statutory requirements. Indeed, the FERC was able to cite only two isolated cases to the court of appeals in which these clauses were ultimately approved; neither case involved a dispute about the clause or an examination of the justification for its adoption.[52] Moreover, to the extent that these clauses have been approved in unreported proceedings involving affiliates, the only importance of the "affiliate" point is to provide the explanation that the issue was probably undisputed, and the case settled, because all parties were part of the same corporate family. When all parties to a tariff agree on its adoption, the FERC is prone to approve the tariff without a stringent review.

51/ *Id.*

52/ The cases were *American Electric Power Co.*, Opinion No. 50 (1979), 19 Fed. Pow. Serv. 5-869, *aff'd sub nom. Ohio Power Co., et al v. Federal Energy Regulatory Commission*, 668 F.2d 880 (6th Cir. 1982) and *Arizona Public Service Co.*, 54 FPC 1232, 54 FPC 1984 (1975). The FERC cited two other cases involving the use of these clauses. In one, the FERC found that these provisions are "unjust and unreasonable and in contravention of §205 of the statute. . . ." A court of appeals remanded the issue for further consideration, but ultimately the rejection of the clause was upheld. *South Carolina Generating Co. v. Federal Power Commission*, 249 F.2d 755, 765 (1957), 261 F.2d 915 (4th Cir. 1958). In the other, a court of appeals determined that no adequate showing was made to permit a departure from the normal regulatory process. *American Louisiana Pipe Line Co. v. Federal Power Commission*, 344 F.2d 525 (D.C. Cir. 1965).

The involvement of affiliates is a reason to disapprove, not approve, automatic adjustment clauses. If inequities arise in a formula tariff involving unrelated corporations, the injured party is likely to provoke a regulatory review. In the case of affiliates, on the other hand, a corporate decision may ordain that one company suffer a loss in order to gain an overall advantage for the corporate family. In this case, inequities suffered by ratepayers are not likely to be called to the attention of the FERC by an individual operating company.

Second, the potential for "upward and downward"[53] adjustments is no basis for abandonment of regulatory review. This observation is true of an automatic adjustment clause in any context. The Federal Power Act prohibits *any change* in rates without a regulatory filing.[54] In this case, inequity may be caused to the ratepayers of a "long" company from a downward change in the rate, just as it may be caused to the ratepayers of a "short" company from an upward change.

Third, the possibility of an audit or investigation is not a basis for abrogation of the normal regulatory process. The FERC always has the right of audit; it has not determined to take any special investigative steps with respect to the MSU System. Moreover, this possible safeguard has failed in the past to uncover improprieties in the tariff, including the practice of including deferred taxes in the rate base, which violated FERC regulations. Thus, it offers little solace to intrastate ratepayers.

53/ Opinion No. 124, R. 2021-36, at 5; App. at A-2.

54/ 16 U.S.C. §824d.

In contrast to the absence of evidence supporting the adoption of the automatic adjustment clauses, there is substantial evidence establishing that these clauses have resulted in unjust rates. For instance, the accumulated deferred taxes associated with various participation units were included in the rate base used to compute the tariff from 1973 to 1980 in violation of FERC regulation.[55] This practice would not have been permitted in Louisiana.[56] Moreover, the chief MSU witness conceded that abnormal costs were included in operation and maintenance and overhead expenses used to fix the rate. The total amount of the abnormal expense in 1977 and 1978 was nearly $25 million.[57] The inclusion of these costs is contrary to proper regulatory policy.[58]

The "good cause" requirement for waiver of the regulatory process requires more than a bare description of the transaction. In this case, no evidentiary or policy basis has been cited as justifying regulatory abdication. This Court should review the case to determine the circumstances under which the FERC may abandon its statutory duty.

55/ *See* Opinion No. 124, R. 2021-36, at 13; App. at A-2.

56/ *E. g., Ex Parte South Central Bell Telephone Co.*, 15 PUR 4th 87, 111 (La. Pub. Serv. Comm. 1976).

57/ R. 296.

58/ The FERC conceded in the court of appeals that a regulatory body should delete "these unrepresentative costs from the estimated costs of service upon which rates will be based." Brief for Respondent Federal Energy Regulatory Commission at 13, *Louisiana Public Service Commission v. Federal Energy Regulatory Commission*, 688 F.2d 357 (5th Cir. 1982).

II. THE WRIT SHOULD BE GRANTED TO DETERMINE WHETHER, IN THE CONTEXT OF PREEMPTION OF STATE RATEMAKING AUTHORITY, THE FERC MAY ABANDON THE NORMAL REGULATORY PROCESS.

Although the MSU tariff is subject to the interstate jurisdiction of the FERC, all the charges assessed under the tariff are collected from consumers in intrastate rate cases. The regulatory agencies in the state where the operating companies are "short," including the Louisiana Commission, must increase intrastate tariffs to include the charges paid by the "short" company to its affiliates. However, under the preemption doctrine, these agencies cannot reduce or otherwise adjust the charges to reflect proper ratemaking principles. Because the responsibility for ensuring fairness has been given the FERC, the state regulatory agencies must simply accept the charge.

We do not contend that Congress is unable under its Commerce Clause power to preempt the area of interstate electric regulation or that this action necessarily violates the tenets embodied in the Tenth Amendment. However, we do believe that the federal-state tensions arising from this preemption give added content to the policy of the Federal Power Act requiring adherence to the normal regulatory process. Congress could not have intended to preclude the states from taking any action to protect consumers while permitting the FERC to abandon its own right of review.

The application of the preemption doctrine in this context is reflected in a line of cases decided by the state courts. For instance, in *United Gas Corp. v. Mississippi Public*

Service Commission,[59] the Supreme Court of Mississippi held that the state regulatory commission could not disallow gas charges between affiliated corporations where the Natural Gas Act vested jurisdiction in the FPC to establish the rate. The court determined that the FPC could and would protect the public: "There is nothing to suggest that the FPC will not closely scrutinize the relationship, for the statutory purpose of protecting the public and consumers from exploitation."

Similarly, in *Narragansett Electric Co. v. Burke,*[61] the Supreme Court of Rhode Island held that the preemption doctrine precluded the state regulatory body from disallowing expenses incurred under a tariff subject to FPC jurisdiction. The court cited and relied on the Mississippi case, including the notation that the FPC presumably would discharge its duty to protect the public and consumers.[62] In another leading case, *City of Chicago v. Illinois Commerce Commission,*[63] the court determined that the state commission was "without power to consider the reasonableness of the FPC rates . . . ."[64] It relied in part on the observation that the FPC would "obey the Congressional mandate" to closely scrutinize the arrangement for the statutory

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59/ 240 Miss. 405, 127 So.2d 404 (1961).

60/ 127 So.2d at 420.

61/ 381 A.2d 1358 (R. I. 1977).

62/ *Id.* at 1362-63.

63/ 13 Ill.2d 607, 150 N.E.2d 776 (1958).

64/ 150 N.E.2d at 781.

purpose of protecting the public interest.[65]

These cases indicate that a state regulatory body must approve and flow through any expenses incurred by a utility under a federal tariff. The federal imprimatur stamps the charges as *per se* reasonable for intrastate ratemaking purposes. Ironically, these cases also indicate that the charges could be assessed by the state agencies to consumers under automatic adjustment clauses in view of their presumptive fairness.[66]

Each of the preemption cases is premised on an assumption that the federal agency will conduct a proper regulatory review. Indeed, the conclusion that Congress intended to preempt state power is premised on the determination that Congress mandated the federal agency to perform its regulatory functions. These precedents establish that, in the context of preemption, only a very strong showing of necessity will justify abandonment of the regulatory process embodied in the Federal Power Act.

Other federalism concerns establish that regulatory abdication should generally be prohibited in this context. If the charges under an interstate tariff have not been reviewed by the FERC, but instead reflect the operation of automatic formulae, the state commissions may have good reason to test the limits of the preemption doctrine by disallowing or adjusting the expenses. In other cases, the federal charges may be allowed, but offsetting adjustments in intrastate expenses implemented to determine if the pre-

65/ *Id.* at 780.

66/ *E.g.*, *id.*

emption doctrine precludes this approach. These actions, though reasonable in light of the regulatory waiver of the FERC, would strain the operation of the federal system.

In addition, the requirement of a proper regulatory review is mandated by considerations of full political accountability. The state commissions, which are answerable to consumers, could not abdicate the regulatory process by adopting automatic adjustment clauses for the pass-through of virtually all utility costs. Yet these agencies must assess charges at the state level that have not been subjected to a regulatory analysis. The state commissioners remain accountable for the rates, yet do not even have the assurance that the FERC has performed a regulatory analysis. This result further strains federal-state relations.[67]

The context of preemption gives a special responsibility to the FERC to perform its regulatory function. Therefore, the Court should grant a writ to determine whether a mere description of the tariff, without the citation of evidence or any supporting policy reasons, is sufficient cause to abandon the regulatory process in the preemption context.

CONCLUSION

This case presents an important question of federal regulation arising in a special context. The Court should issue a writ to determine the basis on which the FERC may abandon the normal regulatory process required under the Federal Power Act. Consideration of this case is especially important

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67/ *See Federal Energy Regulatory Commission v. Mississippi*, 102 S.Ct. 2126, 2152 (1982) (O'Connor, J., concurring in part and dissenting in part).

because the federal abdication is occurring in an area in which state ratemaking functions have been preempted. Therefore, a writ should be issued.

Respectfully submitted,

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APPENDIX I

[¶ 61,101]

Middle South Services, Inc., Docket No. ER 79-277

Opinion No. 124; Opinion and Order Affirming in Part and Modifying in Part Initial Decision

(Issued July 30, 1981)

Before Commissioners: C. M. Butler III, Chairman; Matthew Holden, Jr., and J. David Hughes.

[Note: Initial Decision issued November 13, 1980 appears at 13 FERC ¶ 63,032.]

Appearances

Richard M. Merriman, Robert S. Waters and *Lisa H. Powell* for Middle South Service, Inc.

Robert C. McDiarmid, Frances Francis and *J. Mark Davis* for Arkansas Attorney General.

N. M. Morton, Jr. for Arkansas Public Service Commission

Michael R. Fontham for Louisiana Public Service Commission

Robert L. Woods and *L. Jorn Dakin* for Staff, Federal Energy Regulatory Commission

[Opinion No. 124 Text]

Since 1973 Middle South Services, Inc. (MSS) and the four electric utility subsidiaries of Middle South Utilities, Inc. (MSU) [1] have been operating pursuant to an interconnection agreement (System Agreement) under which the operating utilities exchange power and energy on a pool basis. Certain categories of expenses under the System Agreement are subject to automatic adjustment clauses. This proceeding involves a proposal by MSS to expand the categories of expenses subject to the automatic adjustment formulae and to increase the rate of return under the Agreement.

An initial decision was issued in this docket on November 13, 1980. Briefs on and opposing exceptions to the decision were filed by the Louisiana Public Service Commission (Louisiana), MSS and the Commission staff.

We affirm and adopt the initial decision on all issues except automatic adjustment clauses, rate of return, and accumulated deferred taxes.

1/ MSU, a public utility holding company, owns all of the common stock in MSS and the four utilities:Louisiana Power & Light Company, Arkansas Power & Light Company, Mississippi Power & Light Company, and New Orleans Public Service Inc. (At the time the case was filed, MSU owned a fifth utility subsidiary, Arkansas-Missouri Power Company. That subsidiary has since been merged into Arkansas Power & Light Company.) MSS acts as an agent for the MSU subsidiaries in various regulatory matters.

Section 3.01 of the System Agreement under which the MSU subsidiaries exchange power provides a basis for equalizing among the companies any inbalance of costs associated with the construction, ownership and operation of such facilities as are used for the benefit of all the companies. Charges are made under five separate service schedules: (1) capability equalization, (2) transmission equalization, (3) exchange of electric energy, (4) distribution of revenue from sales made for the joint account of all the companies, and (5) distribution of operating expenses of the system operations center. The issues in this proceeding focus on capability and transmission equalization service schedules.

The agreement requires each MSU operating company to have generating capacity and other facilities necessary to supply its own customer requirements. However, the Operating Committee, which is composed of members designated by each of the subsidiaries and the parent company, may also require an individual company to construct, own and operate a new generating unit of sufficient size to achieve economies of scale and help provide capacity for the projected system load. Such a new participation unit ultimately will be needed to meet the native load requirement of the individual operating company, but until the time that company's load growth can absorb the total capacity of the new plant, its output and associated costs are shared by the other subsidiaries according to their respective capability responsibilities as defined in the Agreement.[2]

2/ Section 2.13 of the Agreement defines capability responsibility as system capability multiplied by the responsibility ratio for a company. The responsibility ratio is obtained by dividing a company's load responsibility by the system load responsibility.

Operating companies which own generating capacity less than their capability responsibility ("short" or "buying" companies) are required to pay a capability equalization charge to companies owning generating capacity in excess of their responsibility ("long" or "selling" companies). Equalization payments reflecting the capacity costs of the participation unit are made on a monthly basis. When a new participation unit is installed or when there is a change in investment in an existing participation unit, charges under the Agreement are automatically adjusted to reflect changes in investment and capital costs. Transmission costs are equalized in a similar manner.

Although the service schedules at issue in this proceeding govern the amounts paid and received among the operating companies as a result of the interchange transaction, those payments are accounted for in wholesale and retail regulatory proceedings, primarily at the state level. Payments received by a selling company under the service schedules are treated as revenues in that company's state regulatory proceedings, and may serve to offset the total revenues which the ratepayers in the state must advance to achieve the rate of return permitted in that particular jurisdiction. Likewise, payments made by buying companies are treated as expenses in the buying company's state jurisdiction, and may act to increase the total revenues that state's ratepayers must contribute to provide the rate of return allowed in their jurisdiction.

Automatic Adjustment Clauses

The above described interconnection agreement between the MSU operating subsidiaries contains both capability and transmission cost equalization formulae by which operating companies having excess generating or transmission capacity sell the excess to companies having deficient capacity.

Under the previously approved formulae, operation and maintenance costs, general and administrative overheads attributable to the production function, return on common equity, and the capital structure ratios were fixed, while other components were adjusted automatically as their values increased or decreased. In this proceeding MSS seeks to place operation, maintenance, and general and administrative expenses under automatic adjustment formulae. This would make all costs, except cost of equity, subject to the automatic adjustment clauses. [3]

The presiding judge determined that MSS had not shown "good cause," pursuant to Section 205(d) of the Federal Power Act, [4] to totally exempt it from making a filing with the Commission when changes are made either to the components of the formulae or the numbers which comprise the components. He concluded that MSS should be able to change the numbers in the proposed formulae without having to make a Section 205 filing each time a number is changed, but that it should file an annual report with the Commission, subject to certain requirements set forth at pages 18 and 19 of his decision.

Exceptions to the judge's decision were filed by MSS and

3/ The categories of costs proposed to be recovered through the equalization formulae are: (1) rate of return, (2) depreciation, (3) insurance premiums, (4) taxes, and (5) operation, maintenance, administrative and general expenses. The rate of return would remain fixed.

4/ Section 205(d) provides that the Commission, for good cause shown, may allow rate changes to take effect without requiring the usual statutory 60-day notice requirement.

the Commission staff.[5] MSS objects to the judge's first three reporting requirements because they are designed to apply to all components of the pricing formulae, not just the proposed OM component (which would consist of operation and maintenance and general and administrative overhead expenses). In support of its argument that refund conditions should be restricted to the proposed OM component, MSS states that the other automatic adjusting components, except rate of return on equity, were already approved by the Commission in 1973, and that they are actual recorded costs which are routinely subject to audit by independent outside auditors, local regulatory auditors and the Commission's own audit staff MSS believes any further inquiry into such costs is duplicative and unnecessary.

MSS also claims that the judge's proposal might be construed as requiring that *all* charges collected during certain months would be collected subject to refund, not just those additional revenues resulting from changes in the pricing components. Such a requirement, states MSS, is clearly contrary to Section 205 of the Federal Power Act. MSS would agree to a refund condition which applies only to any additional revenues collected under the proposed OM component during the year succeeding each annual change in the component, as opposed to the potential refund obligation the judge would impose on all revenues collected for the preceding year. It would agree to provide data to support an upcoming change on or before March 31 of each year and then implement the change on June 1. If an investigation

5/ Although Louisiana originally argued that proper resolution of this issue would be to establish a fixed rate which could be changed by MSS only in a Section 205 proceeding, Louisiana did not except to the judge's decision.

were instituted, only the increased revenues collected after June 1 would be subject to refund.

The staff believes the initial decision must be modified either to approve the proposed formulae as the rate, without any review procedure, or, in the alternative, to allow approval of the formulae for a limited term with annual review of the increased charges resulting from operation of the formulae.

It is the staff's first position that the proposed changes to MSS' existing formulae should be allowed *in toto*, without any attached conditions. Staff bases this position on the *Central Power and Light Co.* case,[6] wherein the Commission listed three types of automatic adjustment clauses which had previously been allowed without conditions: (1) fuel adjustment clauses, (2) full cost of service formula tariffs, particularly for unit sales and sales to affiliates, and (3) interchange rates based upon incremental costs. Staff views the MSS proposal in this proceeding as clearly coming within the purview of (2) above.

If the MSS formulae are not accepted as the rate for the entire period of the contract, the staff proposes that they be accepted as the rate subject to review of the entire formulae at the end of each three-year period of their operation, and an annual review of the proposed increases and decreases under the formulae. The staff's annual review proposal, set forth in detail on page 13 of the initial decision, is similar to the judge's proposal except that the review would be based on estimated rather than actual past data and would begin *prior* to the time the formulae rates become effective, as in a regular Section 205 proceeding. According to the

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6/ Docket Nos. EL79-26 and ER79-600, order issued May 2, 1980.

staff, the judge's ruling attempts to review rates that have already been lawful for one year, and to make refunds at this point would be retroactive ratemaking.

The Commission finds that good cause has been shown to accept MSS' proposed formulae as the rate, [7] without any attached review conditions. As stated in *Central Power & Light Company, supra,* the Commission has previously allowed certain types of automatic adjustment clauses without conditions, including full cost of service tariffs for unit sales and sales to affiliates. We find acceptance of the formulae in the instant proceeding particularly appropriate because the proposed formulae provide for upward and downward adjustments in essentially all of MSS' costs, and because the sales involved are among affiliates operating on a pool basis. The costs which are distributed to the operating companies under the formulae will be subject to audit by the commission, as well as investigations which might be commenced under Section 206 of the Federal Power Act.

Rate of Return

Louisiana excepts to the judge's decision that the rate of return on common equity for the formulae should be the cost of equity of the operating companies' parent, MSU. MSS, the staff, and Louisiana except to the judge's decision

7/ We noted in *Central Power & Light Co., supra,* that automatic adjustment clauses are exceptions to the notice and review provisions of the Federal Power Act and that in order to remove the changes in charges under an "automatic" clause from the notice, filing and suspension provisions of Section 205, the Commission must expressly approve the clause as the rate rather than merely accept the contract containing the clause. Mimeo, at 3 . The initial decision did not do this.

that MSU's cost of equity is 13.75 percent. Both MSS and the staff think the rate of return on common equity should be 14 percent, the return requested by MSS. Louisiana thinks the rate of return, based on MSU's cost of equity, should be between 10 and 13.5 percent. We agree with the judge that the rate of return on common equity for the formulae should be the MSU's cost of equity. But we agree with MSS and the staff that the rate of return should be fixed at 14 percent.

Four witnesses recommended equity returns shown on Table I:

Table I

Witness & Sponsor	*Derivation Methods*	*Recommended Range of Return on Common Equity*	*Recommended Rate of Return on Common Equity*
Langum (MSS)	Comparative Risk	14.9%–15.4% 13.4%–13.9%	14.5%*
Randall (Staff)	DCF** and Risk-premium	14.6%–15.3%	15.25%
Louiselle (Louisiana)	Weighted average of returns established in wholesale and retail rate cases of the operating companies.		12.5%
Lurito (Louisiana)	DCF	13.25%–13.8% (if sales were to	

unrelated, independent entities and there were a fixed tariff)
10.0%–13.5%
(if the cost of service feature of the System Agreement affected the stability and level of MSU earnings)

* Although the MSS witness recommended a 14.5 percent rate of return, MSS seeks only a 14 percent return in this proceeding. This is based on a capital structure ratio of 34 percent common equity, 56 percent debt and 10 percent preferred stock.

** Discount Cash Flow.

Louisiana's exceptions are not only to the percentage of return allowed by the judge, but also to the use of *any* traditional rate of return analysis. Louisiana contends that the traditional rate of return standards of the *Hope* and *Bluefield* cases [8] are irrelevant in this proceeding due to the nature of equalization payments. Louisiana bases its argument on three assumptions: (1) that the rate of return on equity embodied in the formulae cannot affect the earnings of the consolidated MSU system; (2) that the rate of return

8/ *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Bluefield Waterworks and Improvement Co. v. Public Service Comm'n of West Virginia*, 262 U.S. 679 (1923).

allowance cannot affect the earnings of the individual operating companies, except during the period of regulatory lag; and (3) that the ability of the MSU system and its "selling" companies to attract capital generally cannot be affected by the cost of equity allowance in the formulae.

Under Louisiana's veiw, the sole consideration in setting the rate of return is the potential discriminatory effect the rate of return allowance may have on ratepayers in the subsidiaries' various jurisdictions. Louisiana claims that if the rate of return on equity is set at a level higher than the weighted average of the wholesale and retail rates of return allowed in the relevant jurisdictions, then ratepayers of "buying" companies will be required to advance revenues to MSU in excess of the cost of service in their jurisdictions, while ratepayers of "selling" companies will receive revenue credits that will reduce their own revenue requirement below the cost of service. The only allowance that minimizes this discrimination, says Louisiana, is the weighted average of 12.5 percent. According to Louisiana, the judge ignored the discrimination issue.

Louisiana further contends that the judge, in setting a rate of return, was in error in focusing on the entire electric operation of the company rather than considering the minimal risk to the "selling" companies operating under the formulae. The risk to the selling companies is virtually zero, alleges Louisiana, because: (1) the formulae are similar to a take or pay rates; (2) the rates are based on computations that include the marginal investment and fixed charge capital costs of the selling companies; and (3) the selling companies avoid the risk of attrition and regulatory lag because all costs except cost of equity are recovered through automatic adjustment clauses.

The Commission does not agree with all of the premises underlying Louisiana's argument that the traditional *Hope* and *Bluefield* standards are irrelevant here. The parties concur that the rate of return on equity cannot affect the earnings of the *consolidated* MSU system since for every dollar received by a "selling" company, there will be a corresponding expense incurred by the "buying" company. However, all parties do not agree with, and the evidence does not support, Louisiana's contention that receipts and payments for pool transactions do not affect the individual operating companies.

All common stock in the MSU subsidiaries is owned by MSU, but each operating company must maintain its own credit worthiness since all long-term financing is done by the individual companies. [9] When the individual subsidiary attempts to sell new bonds and preferred stock to the public, it is evaluated by rate agencies and market investors based not only on its own capital structure and financial status but also on system matters that bear on the company. [10] This is exemplified by the fact that the bond ratings of Mississippi Power & Light Company were recently downgraded partially due to the overall financial deterioration within the MSU system. [11] We cannot conclude that the

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9/ Exh. 9 at 4.

10/ Tr. 233.

11/ Exh. 6 at 5. Standard & Poor's Corp. (S&P) downgraded MP&L's outstanding first mortgage bonds from A to BBB and its outstanding preferred stock from A to BBB. S&P stated in part, "The more pressing capital needs of other system companies would appear to require prior claim on the parent company's financial resources, *particularly common equity.*" (Source: Standard & Poor's Corp., *Fixed Income Investor*, March 8, 1980, p. 938).

rates each subsidiary must pay to obtain needed capital through the sale of bonds and preferred stock will not be affected by the MSU return on common equity. To the extent that the rate of return allowed by this Commission does not reflect MSU's actual cost of equity and does not provide adequate financial security to the bond and preferred stockholders, the returns required by them will increase. Likewise, if Louisiana's proposed weighted average is used, the action of one or more state commissions in setting rates based on a rate of return less than its subsidiary's actual cost of equity will result in a higher overall cost of capital and an offsetting cost increase in the overall cost of equity or in the cost of capitalization through bonds or preferred stock. This can have an effect on ratepayers served by other operating subsidiaries or conceivably on MSU equity financing.

In reference to Louisiana's argument that the rate of return cannot affect the earnings of the individual companies, this would be true only if there were instantaneous regulatory response by the state and federal regulatory commissions to the various pool transactions. We do not think the problem of regulatory lag can be ignored since, as the record shows, a minimum of 18 rate decisions would have been required to maintain a reasonably constant rate of return for each of the operating subsidiaries for the 12-month period ending March 1980.[12]

We agree with Louisiana that this Commission, in determining just and reasonable rates, also has an obligation to consider the potential discriminatory impact of those rates

12/ Exh. 9 at 7. MSS witness Leo also testified on cross-examination that there were some 31 changes in capacity sales in the course of a year. Tr. 274.

on non-jurisdictional customers.[13] However, based on the evidence and arguments presented, we cannot conclude that Louisiana's weighted average theory will necessarily eliminate or minimize discrimination. To eliminate discrimination would require not only that the rates of return for all companies be the same, but that identical regulatory treatment be accorded the companies as to all other rate elements. We agree with the judge that averaging various returns on equity established at different times in different jurisdictions which use different policies, standards and methodologies in setting rates is not the proper way for this Commission to establish a just and reasonable wholesale rate. While some rate discrimination is inherent in the MSU tariff, in theory the "short" companies will become "long"[14] and vice versa over time such that in the long run, any discriminatory effects will cancel each other out and the result will be economies of scale which ultimately benefit all customers of the five subsidiaries.

We also cannot accept Louisiana's contention that the judge erred in focusing on the entire electric operations of MSU. Investors in MSU purchase equity in the entire holding company, not just in the selling companies or in the buying companies[15] Therefore, we do not think it appropriate to consider only the so-called minimal risk to selling companies in establishing a proper rate of return. As pointed out by the judge, this decision is in accord with recent Commission

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13/ *F.P.C. v. Conway Corp.*, 426 U.S. 271, 277-279 (1976).

14/ "Short" companies refers to operating companies which purchase generating capacity or transmission from "long" companies having excess capacity or transmission under the System Agreement.

15/ See *Louisiana Power & Light Co.*, Opinion No. 104, Docket No. ER77-533 (Phase II)(December 16, 1980), slip op. at 9.

opinions.[16]

The exceptions of MSS and the Commission staff are to the percentage of return allowed and the judge's criticisms of their individual rate of return studies. We do not find it necessary to more specifically address the arguments of MSS because the rate of return approved herein is that sought by MSS and because we basically agree with the judge's finding that MSS' rate of return study does not present a sufficient basis for establishing the proper rate of return. The staff's exception to the judge's criticism of its DCF rate of return study is a different matter.[17] The staff witness performed a DCF analysis of MSU. In determining the growth rate the witness examined historical growth rates and extrapolated future growth rates from the data. The witness also estimated

16/ *Missouri Utilities Co.*, Opinion No. 82, Docket Nos. ER77-354 and ER78-14 (March 28, 1980), wherein we affirmed the focus of the rate of return risk analysis on the entire electric operations of a multiple service corporation; *Otter Tail Power Co.*, Opinion No. 93, Docket Nos. ER77-5 and E-8152 (August 15, 1980), wherein we geared the equity return to the company's business as a whole and stated a policy against unbundling of the various functions of the electric business of a utility and apportioning equity return commensurate with the risk of each function; *American Electric Power Service Corp.*, Opinion No. 50, Docket No. E-9408 (July 27, 1979), wherein we made an independent assessment of the cost of equity and established a single rate of return for an interconnection agreement among four subsidiary operating companies of AEP.

17/ The staff witness also presented a risk premium analysis. The risk premium used came from a survey performed by a brokerage house of an unidentified number of institutional investors. The survey is not in the record and has not been shown to have any statistical validity. Accordingly, we affirm the judge's holding that the staff witness' risk premium analysis is entitled to little weight.

future growth rates.[18] The staff witness' judgment was that MSU's historical growth rate could not be maintained in the future.[19] He therefore used his estimated growth rate in determining MSU's cost of equity. The cost of equity the staff witness derived from his DCF analysis was 15.33 percent.

No party criticized the staff witness' estimate of MSU's future growth rate. And the judge found no problem with that estimate. Nevertheless, the judge gave little or no weight to the witness' DCF study. The judge did so solely because the witness had used an estimate. That is not a legitimate criticism of the witness's DCF analysis. We have encouraged DCF analysis because we are interested in forward-looking analysis of rate of return.[20] That presupposes that a witness sponsoring a DCF analysis will consider future growth rates. In doing so the witness may rely solely on extrapolations of past growth rates where those growth rates are expected to continue.[21] But where, as here, past growth rates are not expected to continue the witness may properly estimate future growth rates. Indeed, we have encouraged witnesses to provide "thoughtful, and well-supported, estimates of the growth rate factor."[22] In holding otherwise

18/ Exh. 14, pp. 22-25, 26-27.

19/ *Id.*, at 27.

20/ *Minnesota Power & Light Company*, Opinion No. 12, Docket No. E-8494 (April 14, 1978), slip op. at 11.

21/ *Central Illinois Light Company*, Opinion No. 81, Docket No. ER76-819 (March 20, 1980), slip op. at 21 note 41.

22/ *Id.*, at 21.

the judge erred.

Because the staff witness' estimates of MSU's future growth rates are "thoughtful" and "well-supported" (indeed, they have not been criticized by any party), we find that the staff witness' DCF analysis is entitled to considerable weight. Moreover, because, as the judge found, the other rate of return studies presented are fatally flawed, we find on the basis of the staff witness' DCF analysis that the 14 percent rate of return on common equity requested by MSS is supported by the weight of the record evidence.[23]

Capital Structure Ratios

MSS excepts to the judge's decision that MSU's capital structure ratios should be updated such that current capitalization ratios are used in the cost of service formulae and are changed as MSU's actual capitalization ratios change. MSS claims that the ratios which have been used since 1974 are reflective of financial planning objectives and are those which the operating companies strive to achieve and maintain. It further contends that updating is inconsistent with the establishment of a fixed equity return component.

MSS has not provided sufficient reason to continue using hypothetical "target" ratios which do not reflect its actual capitalization. As shown by Exhibit 20, the actual consolidated capital structure of MSU as of December 31, 1979, was 33.02 percent common equity, 53.39 percent debt and

23/ MSS does not request a rate of return higher than 14 percent. Should MSS determine that because of changed circumstances a 14 percent rate of return is no longer adequate, it is free to make a new filing. *Hampshire Gas Company*, Docket No. RP75-97 (March 21, 1979), *mimeo* at 18-19.

13.59 percent preferred stock. This is in contrast to MSS's fixed hypothetical capital structure of 34 percent common equity, 56 percent debt and 10 percent preferred stock.

We affirm the judge's conclusion that Commission precedent supports the use of the latest available evidence of a company's capital structure. As MSU's actual capitalization ratios change, they should be reflected in the cost of service formulae approved herein.

Accumulated Deferred Taxes

Louisiana excepts to the judge's conclusion that it waived its right to present argument on the issue of accumulated deferred taxes that become available through the use of accelerated depreciation for tax purposes, and that these sums should be eliminated from the investment used to compute the rate because they are consumer supplied.

Although we affirm the judge's ruling on the waiver issue, we find it appropriate to raise the issue on our own motion and to direct MSS to remove accumulated deferred taxes from rate base. Section 2.12 of our regulations states the Commission's policy to deduct from rate base balances in Account 282 of the Uniform System of Accounts, "Accumulated deferred income taxes–Other property." This general policy is also reflected in Opinion No. 12[24] and Order No. 144.[25] We find it essential that proper cost of

24/ Supra note —.

25/ Final Rule Requiring Tax Normalization and Order Removing Refund Contingencies, Docket Nos. RM80-42, R-424 and R-446 (May 6, 1981), at 60-61.

service elements be reflected in the rates approved here since we are approving formula rates which are not subject to any review conditions.

The Commission orders:

(A) The initial decision issued in this docket on November 13, 1980, is affirmed and adopted to the extent not modified herein.

(B) Any exceptions to the initial decision not granted herein are denied.

(C) The rates filed by MSS, which are in effect in this docket subject to refund, are disallowed to the extent they do not conform to this order.

(D) Within 90 days after the date of issuance of this order, MSS shall file any necessary amendments to the System Agreement and service schedules thereunder to the extent they do not conform with the findings and conclusions of this order.

(E) Within 90 days after the date of issuance of this order, the operating subsidiaries of Middle South Utilities, Inc., shall refund to their customers any amounts collected in excess of those amounts which would have been payable under the rates and charges approved in accordance with Ordering Paragraph (D), above, together with interest at the rates established by the Commission, from the date of payment to the date of refund.

(F) The motion for oral argument filed in this docket on February 3, 1981, by the Louisiana Public Service Commission is denied.

Commissioner Holden voted present.

APPENDIX II

LOUISIANA PUBLIC SERVICE COMMISSION, Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION, Respondent.

No. 81-4470

United States Court of Appeals, Fifth Circuit

Oct. 4, 1982

Federal Energy Regulatory Commission expanded categories of expenses subject to automatic adjustment formula and interest rate of return on common equity allowed under agreement for interstate sales of power among affiliated electric utilities, and state Public Service Commission sought judicial review. The Court of Appeals, Johnson, Circuit Judge, held that: (1) Commission's decision to utilize automatic adjustment clause was not invalid; (2) good cause was demonstrated to support exception to general notice requirement of Federal Power Act; (3) rate of return on common equity at 14% complied with statutory requisites; and (4) Commission did not err in focusing on electric operations of entire system in setting rate of return.

Affirmed.

1. Public Utilities key 195

Litigant seeking to overturn rate decision of Federal Energy Regulatory Commission must make convincing

showing that it is invalid because it is unjust and unreasonable under the circumstances. Federal Power Act, §205(a) as amended 16 U.S. C.A. §824d(a).

2. Public Utilities key 194

In reviewing decision by Federal Energy Regulatory Commission, Court of Appeals is without authority to set aside any rate selected by Commission which is within "zone of reasonableness." Federal Power Act, §205(a) as amended 16 U.S.C.A. §824d(a).

3. Public Utilities key 122

Federal Energy Regulatory Commission is not bound to single rate-making method or formula, but is free to make pragmatic adjustments in its methods.

4. Public Utilities key 194

In reviewing facts relied upon by Federal Energy Regulatory Commission in reaching its decision, Court of Appeals must only decide whether facts relied upon by Commission are supported by substantial evidence. Federal Power Act, §313(b) as amended 16 U.S.C.A. §825l(b).

5. Electricity key 11.3(1)

Decision by Federal Energy Regulatory Commission to utilize automatic adjustment clause in setting rates for interstate sales of power among affiliated electric utilities was not invalid. Federal Power Act, §205(a, f) as amended 16 U.S.C.A. §824d(a,f).

6. Electricity key 11.3(4)

Good cause existed to allow deviation from general notice provisions of Federal Power Act so as to allow expansion of category of expenses subject to previously approved automatic adjustment formula used in determining rates for interstate sales of power among affiliated electric utilities. Federal Power Act, §205 as amended 16 U.S.C.A. §824d.

7. Electricity key 11.3(5)

Rate of return on common equity at 14% for affiliated electric utilities among which interstate sales of power occurred complied with statutory requisites where such rate of return did not reach unreasonable and unjust results, did not unduly discriminate against ratepayers and was supported by substantial evidence.

8. Electricity key 11.3(5)

Where investors in affiliated electric utilities among which interstate sales of power occurred purchased equity in entire holding company, not merely in "selling" companies or "buying" companies, Federal Energy Regulatory Commission did not err in focusing on electric operations of entire system in setting rate of return on common equity. Federal Power Act, §205(b) as amended 16 U.S.C.A. §824d(b).

Michael R. Fontham, Paul L. Zimmering, New Orleans, La., Marshall B. Brinkley, Gen. Counsel, Louisiana Public Service Com'n, Baton Rouge, La., for petitioner.

Norma Rosner, F. E. R. C., Washington, D. C., for respondent.

Richard M. Merriman, Robert S. Waters, Washington, D. C., for Middle South Services, Inc.

Petition for Review of an Order of the Federal Energy Regulatory Commission.

Before CLARK, GARZA, and JOHNSON, Circuit Judges.

JOHNSON, Circuit Judge:

Petitioner, the Louisiana, Public Service Commission (Louisiana Commission), seeks review of a decision of the respondent, the Federal Energy Regulatory Commission (FERC), involving the rates set by FERC for interstate sales of power among four affiliated electric utilities. The four affiliated electric utilities, collectively known as the Middle South Utilities System (MSU), sought expansion of the categories of expenses subject to a previously approved automatic adjustment formula and an increase in the rate of return allowed under the MSU system agreement (Agreement). The order of FERC, which affirmed in part and modified in part the decision of the administrative law judge, expanded the categories of expenses subject to the automatic adjustment formula and increased the rate of return allowed under the Agreement. Having concluded that FERC's decision is supported by substantial evidence and results in a just and reasonable rate that does not unduly discriminate against ratepayers, this Court affirms.

I. *The Middle South Utilities System and Its Operation:*

MSU is composed of Middle South Utilities, Inc., a public

utility holding company, Middle South Services, Inc. its subsidiary-agent for regulatory matters, and four electric utility subsidiaries: Louisiana Power and Light Co., Arkansas Power and Light Co., Mississippi Power and Light Co. and New Orleans Public Service, Inc. The Agreement, approved as the operating tariff by FERC in 1973, composes the contractual framework for the interchange of power among the four affiliated electric utilities. 49 FPC 1472 (June 29, 1973). Section 3.01 of the Agreement provides that the purposes of the Agreement are:

> . . . to provide the contractual basis for the continued planning, construction, and operation of the electric generation, transmission and other facilities . . . and to provide a basis for equalizing among the Companies any imbalance of costs associated with the construction, ownership and operation of such facilities as are used for the mutual benefit of all the Companies.

Charges under the Agreement are made under five separate service schedules: (1) capability equalization, (2) transmission equalization, (3) exchange of electric energy, (4) distribution of revenue from sales made for the joint account of all the companies, and (5) distribution of operating expenses of the system operations center. The issues in this appeal revolve around capability and transmission equalization service schedules.

The Agreement requires each of the affiliated utility companies to maintain the generating capacity and other facilities necessary to supply its own local requirements. However, in order to achieve economies of scale through the construction of large units, an individual utility may be required to construct, own, and operate a new generating unit of sufficient size to help provide the power necessary

to obtain the operating requirements of the entire MSU system. A utility that has a generating capacity less than its respective responsibility (a "short" or "buying" company) is required to pay a capability equalization charge to utilities generating, or capable of generating, power in excess of their respective responsibilities ("long" or "selling" companies).

Although the service schedules at issue in this proceeding govern the amounts paid and received among operating companies as a result of system-wide transactions, the same payments and receipts are accounted for in wholesale and retail regulatory proceedings in the respective states of each utility. In other words, the amounts received by a "selling" company may be utilized as income in determining the rates that ratepayers in the "selling" company's territory must pay in order to achieve the rate of return permitted in that particular territory. Likewise, payments made by a "buying" company may be considered expenses in determining the rates that ratepayers in the "buying" company's territory must pay in order to achieve the rate of return permitted in that particular territory. Consequently, the amounts charged ratepayers of different territories are dependent upon the status of the utility operating in each territory.

Under the previously approved operating tariff, operation and maintenance costs, general administrative over-heads attributable to the production function, return on common equity, and the structure ratios were fixed, but, the other components were adjusted automatically as their values increased or decreased. MSU, through its subsidiary-agent, Middle South Services, Inc., sought to place operation, maintenance, and general and administrative expenses under the automatic adjustment formula, thereby making all costs, except cost of equity, subject to the automatic adjustment

formula. FERC granted MSU the requested changes in the automatic adjustment formula, and, furthermore, increased the rate of return on common equity to 14%. Louisiana Commission has perfected this appeal complaining of FERC's decision as to the appropriate expenses subject to the automatic adjustment formula and the proper return on common equity.

II. *The Standard of Review:*

[1-4] A litigant seeking to overturn a rate decision of FERC must make a "convincing showing that it is invalid because it is unjust and unreasonable under the circumstances." *FPC v. Hope Natural Gas Company*, 320 U.S. 591, 64 S.Ct. 281, 288, 88 L.Ed. 333 (1944); *United Gas Pipe Line v. FERC*, 618 F.2d 1127, 1131 (5th Cir. 1980). In reviewing a decision by FERC, this Court is "without authority to set aside any rate selected by the Commission which is within a 'zone of reasonableness' ". *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 88 S.Ct. 1344, 1360, 20 L.Ed.2d 312 (1968) (quoting *FPC v. Natural Gas Pipeline Company*, 315 U.S. 575, 62 S.Ct. 736, 743, 86 L.Ed. 1037 (1942). Additionally, FERC is not "bound to a single rate making method or formula, but is free to make pragmatic adjustments in it's methods." *Arkansas, Louisiana Gas Co. v. FERC*, 654 F.2d 435 (5th Cir. 1981). Moreover, in reviewing the facts relied upon by FERC in reaching its decision, this Court must only decide whether the facts relied upon by FERC are supported by substantial evidence. 16 U.S.C. §825(b) (1976); *In re Permian Basin Area Rate Cases*, 88 S.Ct. at 1372.

III. *Automatic Adjustment Clauses:*

[5] 16 U.S.C. §824d(a) requires FERC to review public

electric utility rates for reasonableness. However, §824d(f) authorizes the use of an automatic adjustment clause in the computation of utility rates when the use of such a clause would result in the "efficient use of resources" and the "economical purchase and use of fuel, electric energy, and other items." 16 U.S.C. §824d(f) (1976). Additionally, FERC is required to review periodically the use of such clauses for efficiency and to determine:

> whether any such clause reflects any costs other than costs which are—
> (i) subject to periodic fluctuations and
> (ii) not susceptible to precise determinations in rate cases prior to the time such costs are incurred.

16 U.S.C. §824d(f)(1)(B). Although the statute specifies criteria to be used by FERC in reviewing the use of automatic adjustment clauses, the statute does not state that the use of such clauses is restricted to unstable, unpredictable expenses. In fact, in 1978 Congress specifically recognized FERC's practice of authorizing an automatic adjustment formula to operate as a rate. Under §208 of the Public Utility Regulatory Policies Act of 1978 (PURPA), FERC is required to review the use of automatic adjustment clauses. Public Utility Regulatory Policies Act of 1978, Pub.L.No. 95-617, 92 Stat. 3117 *et seq.* (1978). Significantly, however, the Conference Report accompanying PURPA states that "the conferees do not indicate any preference for inclusion or exclusion of any item in an automatic adjustment clause." H.R.Rep. No. 95-1750, 95th Cong. 2d Sess. 96 (1978) U.S. Code Cong. & Admin. News 1978, pp. 7659, 7830. Therefore, this Court, recognizing that FERC's order is "the product of expert judgment which carries a presumption of validity. . . .," holds that FERC's decision to utilize

the automatic adjustment clause in the instant case is not invalid. *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 64 S.Ct. 281, 288, 88 L.Ed. 333 (1944); *United Gas Pipe Line v. FERC*, 618 F.2d 1127 (5th Cir. 1980), cert. denied, 450 U.S. 911, 101 S.Ct. 1349, 67 L.Ed.2d 335 (1981). However, our inquiry does not end here.

[6] 16 U.S.C. §824d provides that:

> Unless the Commission otherwise orders, no change shall be made by any public utility in any such rate, except after sixty days notice to the Commission and to the public. The Commission, for good cause shown, may allow changes to take effect without requiring the sixty days' notice herein provided for by any order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

16 U.S.C. §824d (Supp. 1982). Louisiana Commission contends that FERC erred in finding good cause to extend the scope of expenses computed under the automatic adjustment clauses. In response, FERC maintains that its decision to extend the scope of expenses allowed under an automatic adjustment clause is supported by the decision in *Central Power and Light Co.*, 11 FERC ¶61,101 (1980), wherein FERC noted its decision to allow the use of automatic adjustment clauses, without conditions, in full cost of service tariffs for unit sales and sales to affiliates. This Court affirms FERC's decision that good cause has been demonstrated to support an exception to the general notice requirement of §824d. 16 U.S.C. §824d (Supp. 1982).

As FERC noted in its decision, the use of automatic adjustment clauses in the instant proceeding is "particularly appropriate because the proposed formula provide[s] for upward and downward adjustments . . . and because the sales involved are among affiliates operating on a pool basis." *Middle South Services, Inc.,* FERC Opinion No. 124 at 5. Moreover, as FERC contends, under the automatic adjustment clause formula, ratepayers can be assured that they will be required to pay only for actual increases and decreases in cost. This is true because the automatic adjustment formula itself, rather than an estimated unit charge, constitutes the rate. It should be noted that the accuracy of the costs included under the formula could be verified by FERC audit, or by an investigation instituted under §206 of the FPA. Therefore, this Court concludes that FERC's decision that good cause exists to allow deviation from the general notice provisions of §824d is supported by substantial evidence. *See* 16 U.S.C. §825l(b)(1976); and *In re Permian Basin Area Rate Cases,* 88 S.Ct. at 1372.

IV. *Rate of Return:*

[7] Louisiana Commission argues that FERC's decision to set the rate of return on common equity at 14 percent is erroneous. It maintains that FERC erred in utilizing the traditional cost of analysis in arriving at the appropriate rate of return due to the unique nature of the interaffiliate transactions that take place under the Agreement. *See FPC v. Hope Natural Gas Co.,* 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944); *Bluefield Water Works and Improvement Co. v. Public Service Commission,* 262 U.S. 679, 43 S.Ct. 675, 67 L.Ed. 1176 (1923). This Court holds that the result reached by utilization of FERC's method of arriving at the proper rate of return is not unjust and unreasonable, and, therefore, affirms FERC's decision to set the rate

of return for MSU at 14%.

In reviewing a rate of return set for a utility by FERC, this Court must determine whether the rate set is "just and reasonable." 16 U.S.C. §824d(b). At the same time, §824d (b) prohibits a utility from granting any "undue preference or advantage to any person," subjecting anyone to "an undue prejudice or disadvantage," or maintaining any "unreasonable difference in rates [or] charges. . . between classes of service." 16U.S.C. 824d(b). However, it should be noted that it is the *result* of the rate that must comply with these statutory requirements, not the *method* employed in arriving at the contested rate. *Los Angeles Gas & Electric Corp. v. Railroad Commission,* 289 U.S. 287, 53 S.Ct. 637, 643, 647, 77 L.Ed. 1180 (1933); *West Ohio Gas Company v. Public Utility Commission,* 294 U.S. 63, 55 S.Ct. 316, 320, 79 L.Ed. 761 (1935); and *Arkansas, Louisiana Gas Co. v. FERC,* 654 F.2d at 437.

Louisiana Commission argues strenuously that the discriminatory impact upon ratepayers caused by FERC's method of establishing the rate of return demonstrates the unreasonableness and unjustness of the rate of return set for MSU. Commendably, MSU's system seeks to operate its interaffiliated affairs in a manner that will save money for ratepayers of the operating companies by maximizing efficiency and reducing costs. Admittedly, the system results in rate differences in the various jurisdictions occasioned by the natural operation of multiple regulatory systems. For example, the ratepayers in a "buying" company's territory may be required to pay higher rates so that the "buying" company can achieve the maximum return of common equity allowed by FERC. However, as FERC noted in its decision, "in theory the 'short' companies will become 'long' and vice versa over time so that, in the long run, any

discriminatory effects will cancel each other out and the result will be economies of scale which ultimately benefit all customers of the five subsidiaries." *Middle South Services, Inc.*, FERC Opinion No. 124 at 9-10. Moreover FERC concluded that Louisiana Commission's weighted average theory would not necessarily eliminate or minimize discrimination. FERC noted that "[t]o eliminate discrimination would require not only that the rates of return for all companies be the same, but that identical regulatory treatment be accorded the companies as to all other rate elements." *Middle South Services, Inc.*, FERC Opinion No. 124 at 9. In light of FERC's conclusions, which this Court determines are supported by substantial evidence, the Court concludes that the rate of return complies with the statutory requisites.

[8] Louisiana Commission also contends that FERC erred in approving the administrative law judge's decision to focus on the entire electric operations of MSU in setting the rate of return. However, investors in MSU purchase equity in the *entire* holding company, not just in the "selling" companies or "buying" companies. Once again, although rate discrepancies may exist from time to time in the various territories, in the long run "short" companies will become "long" companies and vice versa. Hence, FERC did not err in focusing on the entire electric operations of MSU in setting the rate of return. *See Cities of Aitken v. FERC*, No. 80-2375 (D.C.Cir. March 5, 1982).

Having concluded that the rate of return does not reach unreasonable and unjust results, does not unduly discriminate against ratepayers, and is supported by substantial evidence, this Court affirms FERC's approval of a 14% rate of return.

V. *Conclusion:*

In summary, this Court holds that FERC did not err in approving the extension of expenses allowed under the automatic adjustment clause utilized by the Middle South Utility System. Also, this Court concludes that FERC did not err in approving a 14% rate of return on common equity. Therefore, the decision of FERC is affirmed.

AFFIRMED.

APPENDIX III

STATUTORY PROVISIONS

16 U.S.C. §824d(b):

(d) Unless the Commission otherwise orders, no change shall be made by any public utility in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after sixty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the sixty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

16 U.S.C. §824d(f):

(f) (1) Not later than 2 years after November 9, 1978, and not less often than every 4 years thereafter, the Commission shall make a thorough review of automatic adjustment clauses in public utility rate schedules to examine—

> (A) Whether or not each such clause effectively provides incentives for efficient use of resources (including economical purchase and use of fuel and electric energy), and

(B) Whether any such clause reflects any costs other than costs which are–

(i) subject to periodic fluctuations and

(ii) not susceptible to precise determinations in rate cases prior to the time such costs are incurred.

Such review may take place in individual state proceedings or in generic or other separate proceedings applicable to one or more utilities.

(2) Not less frequently than every 2 years, in rate proceedings or in generic or other separate proceedings, the Commission shall review, with respect to each public utility, practices under any automatic adjustment clauses of such utility to insure efficient use of resources (including economical purchase and use of fuel and electric energy) under such clauses.

(3) The Commission may, on its own motion or upon complaint, after an opportunity for an evidentiary hearing, order a public utility to–

(A) modify the terms and provisions of any automatic adjustment clause, or

(B) cease any practice in connection with the clause,

if such clause or practice does not result in the economical purchase and use of fuel, electric energy, or other items, the cost of which is included in any rate schedule under an automatic adjustment clause.

(4) As used in this subsection, the term "automatic adjustment clause" means a provision of a rate schedule which provides for increases or decreases (or both), without prior hearing, in rates reflecting increases or decreases (or both) in costs incurred by an electric utility. Such term does not include any rate which takes effect subject to refund and subject to a later determination of the appropriate amount of such rate.

No. 82-1121

In the Supreme Court of the United States

OCTOBER TERM, 1982

LOUISIANA PUBLIC SERVICE COMMISSION, PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE FEDERAL ENERGY REGULATORY COMMISSION IN OPPOSITION

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QUESTION PRESENTED

Whether the Federal Energy Regulatory Commission properly allowed existing automatic adjustment clauses in a public utility rate tariff, involving sales among affiliated companies, to be expanded when such clauses reflect actual increases and decreases in costs incurred by the utility.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A-21 to A-33) is reported at 688 F.2d 357. The decision and order of the Federal Energy Regulatory Commission (Pet. App. A-2 to A-20) are reported at 16 F.E.R.C. (CCH) ¶ 61,101, *sub nom. Middle South Services, Inc.* The decision and order of the administrative law judge are reported at 13 F.E.R.C. (CCH) ¶ 63,032 (Nov. 13, 1980).

JURISDICTION

The judgment of the court of appeals was entered on October 4, 1982. The petition for a writ of certiorari was filed on December 30, 1982. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 313(b) of the Federal Power Act, 16 U.S.C. 825*l*(b).

STATUTE INVOLVED

Sections 205(d) and 205(f) of the Federal Power Act, 16 U.S.C. (Supp. V) 824d(d) and 824d(f), are set forth at Pet. App. A-34 to A-36. Section 205(e) and Section 206 of the Act, 16 U.S.C. 824d(e) and 824e, are set forth in an appendix to this brief, *infra*, 1a-2a.

STATEMENT

1. Middle South Utilities, Inc., is a public utility holding company with four electric utility operating subsidiaries that sell electricity at wholesale and at retail in Mississippi, Arkansas, Missouri and Louisiana. Middle South also has a service subsidiary, Middle South Services, Inc., that acts as an agent for the operating subsidiaries (Pet. App. A-3 to A-4). Since 1973, the operating subsidiaries have operated under an interconnection agreement, known as the System Agreement, which provides, *inter alia*, for the coordinated exchange (pooling) of power and energy among members of the Middle South System. Since the System Agreement is a wholesale rate schedule, it must be filed with the Commission pursuant to Section 205 of the Federal Power Act, 16 U.S.C. (& Supp. V) 824d.[1] The original System

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[1] Section 205(c) of the Act, 16 U.S.C. 824d(c), provides that every public utility shall file with the Commission its rate schedules for any transmission or sale subject to the Commission's jurisdiction. Under Section 205(d), 16 U.S.C. (Supp. V) 824d(d), utilities must also file with the Commission any proposed changes in its rate schedules at least 60 days before the effective date of such changes; the Commission may, on a showing of good cause, waive the 60-day notice requirement. Section 205(e), 16 U.S.C. 824d(e), provides that the Commission may suspend any new schedule for a period of up to five months and may investigate the lawfulness of such new rates. If the Commission's investigation is not completed within the five month period, the utility may collect the new rates, subject to refund, if the Commission ultimately determines that the rates are unlawful in whole or in part.

Agreement was filed with the Commission in 1973, and an amendment to that agreement was filed in 1979 as a rate change under Section 205 of the Federal Power Act. Middle South Services, Inc., acting as agent for the operating companies, submitted the amendment for filing (Pet. App. A-3). Under the 1973 Agreement, several categories of expenses were subject to "automatic adjustment clauses."[2] The 1979 amendment expanded the coverage of the automatic adjustment clauses to include all items of cost except the rate of return on equity, which was fixed and was not subject to change without the filing by the utility of new rates (*id.* at A-6).[3]

2. The Commission accepted the amendment for filing but suspended its effectiveness until June 1, 1979. At that time the amendment became effective, subject to refund. The issue of the justness and reasonableness of the rate was set for hearing. Petitioner, the Louisiana Public Service Commission, intervened in the hearing and participated as a party. At the conclusion of the hearing, the administrative law judge (ALJ) issued a decision approving the automatic adjustment clauses

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In contrast to Section 205, which governs newly filed rates, Section 206, 16 U.S.C. 824e, provides that the Commission may proceed to determine whether existing rates are unjust or unreasonable. If the Commission makes such a determination, it shall by order fix the just and reasonable rate for the future.

[2] Section 205(f)(4) of the Federal Power Act, 16 U.S.C. (Supp. V) 824d(f)(4), provides:

> [T]he term "automatic adjustment clause" means a provision of a rate schedule which provides for increases or decreases (or both), without prior hearing, in rates reflecting increases or decreases (or both) in costs incurred by an electric utility. Such term does not include any rate which takes effect subject to refund and subject to a later determination of the appropriate amount of such rate.

[3] The 1979 amendment also included a change in the rate of return on common equity.

but requiring Middle South to file annual reports on the costs of the system (see Pet. App. A-6).

On review, the Commission affirmed the ALJ's approval of the automatic clauses, but removed the requirement that Middle South file annual reports (Pet. App. A-2 to A-20).[4] The Commission gave several explanations for its approval of the automatic adjustment clauses. First, it noted (*id.* at A-8) that its consistent policy, as articulated in *Central Power & Light Co.*, 11 F.E.R.C. (CCH) ¶ 61,102 (May 2, 1980), has been to permit three types of automatic adjustment clauses without any attached review conditions: (1) fuel adjustment clauses; (2) full cost of service formula tariffs, particularly for unit sales to affiliates; and (3) interchange rates based upon incremental costs. The Commission found that the proposed amendment fit within the second category, since the transactions the amendment covered were unit sales and sales to affiliates; it held that such clauses were particularly appropriate for affiliates operating on a pooled basis. In addition, the Commission found the automatic adjustment clauses reasonable because they provided for downward, as well as upward, adjustments in cost. Finally, the Commission noted that all costs under the automatic formula would be subject to Commission audit, and to investigation (on the Commission's own motion or by complaint) under Section 206 of the Federal Power Act, 16 U.S.C. 824e. On this basis, the Commission concluded that the automatic clauses were just and reasonable (Pet. App. A-9).

3. On review, the court of appeals affirmed the Commission's decision (Pet. App. A-21 to A-33). The court found the Commission's decision supported by substantial evidence and concluded that the utility had demon-

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[4] The Commission also established a rate of return on common equity. The Commission's determination on rate of return was affirmed by the court of appeals and is not challenged here.

strated good cause for using the automatic formula as the rate rather than having to comply with the notice provisions of Section 205(d) of the Federal Power Act, 16 U.S.C. (Supp. V) 824d(d), whenever it wished to reflect changes in costs among pool members (Pet. App. A-30).

ARGUMENT

The decision of the court of appeals, affirming the Commission's approval of automatic adjustment clauses, is fully in accord with settled legal principles, does not conflict with the decisions of this Court or other courts of appeals, and does not warrant further review.

1. It is well established that ratemaking is not "an exact science" (*FPC* v. *Conway Corp.*, 426 U.S. 271, 278 (1976)), but rather a process in which the expert ratemaking body has considerable latitude. See *Montana-Dakota Utilities Co.* v. *Northwestern Public Service Co.*, 341 U.S. 246, 251 (1951). "A presumption of validity therefore attaches to each exercise of the Commission's expertise, and those who would overturn the Commission's judgment undertake 'the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.'" *Permian Basin Area Rate Cases*, 390 U.S. 747, 767 (1968).

In addition, the Commission's decisions must be upheld on review if supported by substantial evidence. See 16 U.S.C. 825*l*. As this Court has observed:

> [W]hether on the record as a whole there is substantial evidence to support agency findings is a question which Congress has placed in the keeping of the Courts of Appeals. This Court will intervene only in what ought to be the rare instance when the standard appears to have been misapprehended or grossly misapplied. *Universal Camera Corp.* v. *NLRB*, 340 U.S. 474, 491 (1951).

Mobil Oil Co. v. *FPC*, 417 U.S. 283, 310 (1974).

In this case, the court of appeals found (Pet. App. A-30) that the Commission's decision to approve the automatic adjustment clauses was supported by substantial evidence. There is no reason for this Court to disturb that finding.

2. Contrary to petitioner's claims (Pet. 12), approval of an automatic adjustment clause does not constitute "an abandonment of the regulatory process." As the Commission explained (Pet. App. A-9) and as the court of appeals noted (*id.* at A-30), the Commission, through its periodic audits, is capable of detecting any inappropriate costs that may be placed in the formula in the future. In addition, both the Commission and the court below emphasized that automatic adjustment is at all events subject to investigation pursuant to Section 206 of the Federal Power Act, 16 U.S.C. 824e.

The Commission's approval of an automatic adjustment clause is consistent with settled administrative practice and has received judicial approval. The automatic formula approved in this case is also known as a "cost of service tariff," because the formula encompasses all of the elements of a cost of service. Since 1946, the Commission consistently has approved cost of service tariffs in appropriate cases, primarily when the service involved sales to affiliates.[5] Although full cost of service tariffs have not been as widely employed for electric utilities under the Federal Power Act as for

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[5] See *Michigan Gas Storage Co.*, 5 F.P.C. 965 (1946); *Trunkline Gas Supply Co.*, 9 F.P.C. 721, 729 (1950); *American Louisiana Pipe Line Co.*, 16 F.P.C. 779 (1956), on rehearing, 18 F.P.C. 795 (1957); *Pacific Gas Transmission Co.*, 24 F.P.C. 134 (1960); *American Louisiana Pipe Line Co.*, 29 F.P.C. 932 (1963); *Michigan Gas Storage Co.*, 43 F.P.C. 625 (1970); *Maine Yankee Atomic Power Co.*, 52 F.P.C. 76 (1974).

natural gas pipelines under the Natural Gas Act,[6] the Commission has approved the use of automatic fuel adjustment clauses for all utilities.

The fuel adjustment clause, like the automatic cost of service tariff in this case, is a formula that operates as a filed rate. In both cases, the formula eliminates the need to provide the Commission with prior notice of changes in rates so long as those changes are computed in accordance with the formula. Courts that have reviewed Commission-approved fuel clauses have consistently concluded that the Commission has the authority to approve the automatic formula as the filed rate. See *Public Service Co.* v. *FERC*, 600 F.2d 944, 960 (D.C. Cir.), cert. denied, 444 U.S. 990 (1979); *Jersey Central Power & Light Co.* v. *FERC*, 589 F.2d 142 (3d Cir. 1978), cert. denied, 444 U.S. 880 (1979); *Virginia Electric & Power Co.* v. *FERC*, 580 F.2d 710 (4th Cir. 1978); *Maine Public Service Co.* v. *FPC*, 579 F.2d 659 (1st Cir. 1978). No court has suggested that the Commission's approval of a fuel adjustment formula as the rate is an abdication of regulatory responsibility.[7]

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[6] Several cost of service tariffs for electric utilities have been approved. See, *e.g.*, *Maine Yankee Atomic Power Co.*, 52 F.P.C. 76 (1974); *Central Power & Light Co.*, 11 F.E.R.C. (CCH) ¶ 61,102 (May 2, 1980). Because the pertinent provisions of the Federal Power Act and Natural Gas Act are virtually identical (compare 16 U.S.C. (& Supp. V) 824d and 824e with 15 U.S.C. 717c and 717d), the consistent approval over the years of cost of service tariffs under the Natural Gas Act is of obvious relevance to the validity of such tariffs under the Federal Power Act. See *Arkansas Louisiana Gas Co.* v. *Hall*, 453 U.S. 571, 577 n.7 (1981); *Permian Basin Area Rate Cases*, 390 U.S. 747, 820-821 (1968); *FPC* v. *Sierra Pacific Power Co.*, 350 U.S. 348, 353 (1956).

[7] Petitioner mistakenly relies (Pet. 15-16) on two cases for the proposition that automatic adjustment clauses are against public policy. In *Sunray Oil Co.* v. *FPC*, 364 U.S. 137 (1960), the Court affirmed the Commission's refusal to approve a request for a certificate of public convenience and necessity for a limited term. In its analysis, the Court gave an example of a contract

3. Petitioner contends (Pet. 17) that, by amending Section 205 of the Federal Power Act to require the Commission to review periodically the operation of automatic adjustment clauses in rate schedules (16 U.S.C. (Supp. V) 824d(f),[8] Congress intended to permit the use of such clauses "only in the limited circumstances when this action is necessary because normal ratemaking is unworkable." This contention is without merit.

The court of appeals correctly explained that Congress did not intend by this amendment to limit the Commission's ability to approve automatic clauses as a general matter. The court first noted that, although Section 205(f) of the Power Act "specifies criteria to be used by [the Commission] in reviewing the use of automatic adjustment clauses, the statute does not state

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with an escalator clause (that is, a clause providing for increases but not decreases in rates) and said that any adjustment under that contract clause would be subject to the provisions of the Natural Gas Act that parallel Sections 205(d) and 205(e) of the Federal Power Act. The purpose of the Court's example was to point out that a contract term could not supersede the Commission's authority to investigate new rate filings under the Natural Gas Act, not that the Commission lacked the authority to approve such a clause. In *Episcopal Theological Seminary* v. *FPC*, 269 F.2d 228 (D.C. Cir. 1959), the court of appeals affirmed the application of the Commission's regulation that the operation of a clause in natural gas schedules providing for periodic rate increases (*i.e.*, an escalation clause) constituted a change in rates for which a rate filing was required. The court made clear that it agreed with the Commission's concern with escalator clauses in long term contracts because such clauses are not designed to match future rate increases with future costs to the gas company. *Id.* at 233-234. Here, however, the automatic clause approved for the Middle South System will track cost increases and decreases.

[8] This amendment was enacted as Section 208 of the Public Utility Regulatory Policies Act of 1978 ("PURPA"), Pub. L. No. 95-617, 92 Stat. 3142.

that the use of such clauses is restricted to unstable, unpredictable expenses" (Pet. App. A-28). In fact, the court observed (*ibid.*), in its 1978 amendment to Section 205 of the Power Act, "Congress specifically recognized [the Commission's] practice of authorizing an automatic adjustment formula to operate as a rate." The court pointed out (Pet. App. A-28) that the Conference Report accompanying the 1978 amendment states that "[t]he conferees do not indicate any preference for inclusion or exclusion of any item in an automatic adjustment clause." H.R. Rep. No. 95-1750, 95th Cong., 2d Sess. 96 (1978).

As the court of appeals' discussion clearly demonstrates, Congress, which was aware of the Commission's practice of permitting the use of automatic adjustment clauses, would almost certainly have amended Section 205 of the Power Act to restrict the Commission's authority to approve such clauses had their use been considered inconsistent with the purposes of the Power Act. Instead, Congress left it to the Commission to decide, in the exercise of its discretion, whether to allow a formula rate in a particular tariff and whether the formula may reflect some or all of the elements of the cost of service.[9]

4. The Commission found in this case that use of the cost of service formula will not produce excessive rates. Petitioner challenges that finding on substantial evidence grounds. Petitioner claims (Pet. 21): (1) that ac-

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[9] See FERC, *Automatic Adjustment Clauses In Public Utility Rate Schedules, A Staff Report on the Implementation of Section 208 of the Public Utility Regulatory Policies Act of 1978* (1982). In that report, the Commission's staff concluded: "The primary purpose of [cost of service formula] rates is to provide an equitable basis for types of inter-utility transactions that appear desirable to encourage * * *. [These] transactions tend to encourage coordination of plans for increases in capacity." *Id.* at 72.

cumulated deferred taxes were improperly included in Middle South's rate base in the past, and (2) that the approved clause improperly includes recovery of so-called nonrecurring expenses. Neither of these claims has merit.

First, the Commission expressly required Middle South to reduce the rate base by the amount of deferred taxes collected (Pet. App. A-19). The Commission took this action even though petitioner had waived its claim concerning deferred taxes by failing to raise the issue at the hearing before the ALJ (*ibid.*). As a result of this adjustment, the formula will properly reflect the cost of service effect of deferred taxes, now and in the future.

Second, the Commission affirmed the ALJ's determination that certain nonrecurring operating and maintenance expenses were appropriately included in the cost of service formula as just and reasonable costs. *Middle South Services, Inc.*, 13 F.E.R.C. (CCH) ¶ 63,032 at 65,112 (Nov. 13, 1980). As the ALJ, found (*ibid.*), inclusion of these expenses

> * * * is entirely consistent with, and required by cost of service tariffs. The object of such tariffs is to track costs more closely than is possible under a fixed rate tariff. Thus, increased expenses paid by the operating companies, such as those non-recurring expenses of the past, will be reflected in the charges.* * * [T]here has been no such showing or claim here by the Louisiana Commission that past non-recurring expenses were imprudent or improperly incurred.[[10]]

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[10] The ALJ's decision went on to state that the hearing and refund procedure specified in that decision will protect customers from imprudent costs in the future. On review, the Commission dropped the procedure established in the initial decision in favor of periodic audits and investigations under Section 206 of the Federal Power Act (Pet. App. A-9).

Thus, the record discloses that the formula, as approved by the Commission, reflects only those costs legitimately incurred by the Middle South System. As the Commission further explained (Pet. App. A-9), the formula tracks decreases as well as increases in the cost of service, thus removing the Commission's traditional objections to tariffs with only cost escalation clauses. See *South Carolina Generating Co.* v. *FPC*, 19 F.P.C. 855, 860-862 (1957).

5. Finally, petitioner contends (Pet. 11, 22-26) that the use of an automatic formula is particularly inappropriate in this case because "the impact of [the FERC decision] is felt by intrastate ratepayers." However, the impact on intrastate ratepayers here is not different from the impact of any other wholesale rate approved by the Commission. Every rate that the Commission establishes is, under the scheme of the Federal Power Act, a rate for wholesale (sale for resale) interstate service. See 16 U.S.C. (& Supp. V) 824. The wholesale purchaser in each case will pass through the wholesale rate to its retail customers. In this respect, ratepayers in Louisiana are no different from ratepayers in any other state whose utility purchases power from another utility to meet the demands of its customers.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MARCH 1983

APPENDIX

1. Section 205(e) of the Federal Power Act, 16 U.S.C. 824d(e), provides:

> Whenever any such new schedule is filed the Commission shall have authority, either upon complaint or upon its own initiative without complaint, at once, and, if it so orders, without answer or formal pleading by the public utility, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the public utility affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of such five months, the proposed change of rate, charge, classification, or service shall go into effect at the end of such period, but in case of a proposed increased rate or charge, the Commission may by order require the interested public utility or public utilities to keep accurate account in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts are paid, and upon completion of the hearing and decision may by further order require such public utility or public utilities to refund, with interest, to the persons in whose behalf such amounts were paid, such portion of such increased rates or charges as by its decision shall be

found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the public utility, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

2. Section 206 of the Federal Power Act, 16 U.S.C. 824e, provides:

(a) Whenever the Commission, after a hearing had upon its own motion or upon complaint, shall find that any rate, charge, or classification, demanded, observed, charged, or collected by any public utility for any transmission or sale subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affected such rate, charge, or classification is unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order.

(b) The Commission upon its own motion, or upon the request of any State commission whenever it can do so without prejudice to the efficient and proper conduct of its affairs, may investigate and determine the cost of the production or transmission of electric energy by means of facilities under the jurisdiction of the Commission in cases where the Commission has no authority to establish a rate governing the sale of such energy.

No. 82-1121

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

LOUISIANA PUBLIC SERVICE COMMISSION,
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION
and MIDDLE SOUTH SERVICES, INC.
Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

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OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the court of appeals correctly found that there was substantial evidence to support the facts relied upon by the Federal Energy Regulatory Commission to decide a wholesale electric rate case, and gave appropriate deference to that agency's expert judgment in affirming its ratemaking method.

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On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

Middle South Services, Inc. (MSS),[1] intervenor in support of respondent Federal Energy Regulatory Commission (FERC) in the case before the Court of Appeals for the Fifth Circuit and the applicant before the FERC, submits this brief in opposition to the petition for writ of certiorari.

[1] The list of parties to the proceeding supplied by petitioner is correct. In accordance with Rule 28.1 of this Court, a complete listing of all parent companies, subsidiaries and affiliates of respondent Middle South Services, Inc. follows: Middle South Utilities, Inc. (MSU), a registered public utility holding company, is the parent company of, and owns all the common stock in, Middle South Serv-

OPINIONS BELOW

The references to the opinions of the court of appeals and the FERC set forth in the petition are correct.

JURISDICTION

The petition correctly states the grounds on which the jurisdiction of the Court rests.

STATUTORY PROVISIONS

In addition to the provisions cited by petitioner, Section 313(b) of the Federal Power Act, 16 U.S.C. § 825*l*(b), is involved in this case. That section provides in pertinent part that upon review by a court of appeals,

> [t]he finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive.

The full text of Section 313(b) of the Federal Power Act is set forth in the Appendix hereto.

STATEMENT OF THE CASE

Petitioner seeks review of an opinion of the Court of Appeals for the Fifth Circuit affirming a decision of the FERC approving in part and modifying in part a wholesale electric rate change filed by MSS under Section 205 of the Federal Power Act, 16 U.S.C. § 824d. The rate approved by the FERC is for interstate sales of power

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ices, Inc. (MSS) and four electric utility operating companies: Louisiana Power & Light Company, Arkansas Power & Light Company, Mississippi Power & Light Company, and New Orleans Public Service, Inc. Among other things, MSS acts as an agent for these MSU subsidiaries in various regulatory matters.

Three other associated companies are System Fuels, Inc., Middle South Energy, Inc., and Associated Natural Gas Company.

among four affiliated electric utilities that together operate a physically integrated and centrally dispatched electric power system, or pool, known as the Middle South System.[2] The order of the FERC increased the allowance for a rate of return on common equity capital and expanded the categories of expenses that are subject to various automatic adjustment clauses under the System Agreement among the companies. The System Agreement was first approved by the Federal Power Commission (FPC) on June 29, 1973.

a. Course Of Proceedings

This case began in 1979 with the filing by MSS of certain rate change amendments to the System Agreement originally approved by the FPC in 1973. Under the 1973 System Agreement, certain types of expenses were subject to automatic adjustment clauses. MSS proposed to expand the categories of expenses subject to the automatic adjustment clauses, and also to increase the rate of return on equity.

The FERC allowed the amendments to become effective subject to refund, and a hearing was held by the FERC to consider the justness and reasonableness of the proposed changes. MSS, the FERC trial staff, the State of Arkansas, the Arkansas Public Service Commission and the Louisiana Public Service Commission (petitioner herein) participated at the hearing. On November 13, 1980, an administrative law judge issued an initial decision that permitted the expansion sought by MSS of the

[2] The four electric utilities, all subsidiaries of MSU, are listed in footnote 1 above. Together they will be referred to for convenience as the Middle South System or the MSU operating companies.

automatic adjustment clauses, but on condition that MSS file annual cost reports.

Exceptions to the initial decision were taken and briefs were filed with the FERC which, on June 30, 1981, modified and affirmed the initial decision. The FERC agreed with the administrative law judge and authorized expansion of the cost adjustment clauses (previously approved in 1973) to include the costs of operation and maintenance, and general and administrative overheads after they had been incurred and recorded. These cost items had previously been *estimated* in pricing the sales of power among the MSU operating companies. However, the FERC dispensed with the annual cost reports that the administrative law judge had wanted, and instead specifically approved the formulae in the clauses as the filed rate.[3]

Petitioner sought review in the Court of Appeals for the Fifth Circuit which, on October 4, 1982, found that the FERC's decision was supported by substantial evidence and resulted in a just and reasonable rate that did not unduly discriminate against ratepayers, and accordingly affirmed. Specifically, the court held that the FERC's decision to expand the scope of the automatic adjustment clauses in this case was not invalid, affirmed the FERC finding that good cause had been shown to support an exception to the general notice requirement of Section 205 of the Federal Power Act, 16 U.S.C. § 824d, and affirmed the FERC decision as to rate of return on equity.

On December 30, 1982, petitioner filed a petition for writ of certiorari in this Court. MSS sought and was

[3] The FERC also increased the rate of return allowed by the administrative law judge, an issue not raised by petitioners in this Court.

granted an extension of time to and including February 14, 1983, in which to respond to the petition.

b. Statement Of Facts

The System Agreement, approved by the Federal Power Commission as the operating tariff in 1973, provided the contractual framework by which the four MSU operating companies are enabled to obtain the economic, operational, reliability, safety, engineering and environmental benefits of reserve sharing,[4] large power plant construction, and centralized dispatching of power from plants located in a four state area.[5]

Under this arrangement, from time to time a MSU-owned operating company had the responsibility of constructing, owning and operating a new generating unit of sufficient size to achieve economies of scale. Any such new "participation unit" would ultimately be needed to meet the native load requirements of the individual operating company. However, until the time the load growth of the owning company could absorb the total capacity of the new plant, its output and associated costs were to be shared with the other operating companies.

Section 3.01 of the System Agreement provides

> a basis for equalizing among the Companies any imbalance of costs associated with the construction,

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[4] *See* Gainesville Utilities Dept. v. Florida Power Corp., 402 U.S. 515, 518-20 (1971), for a discussion of the reserve sharing concept and its desirability.

[5] *See* Indiana & Michigan Electric Co., 33 FPC 739, 743 (1965), *aff'd*, Indiana & Michigan Electric Company v. FPC, 365 F.2d 180, 181-82 (CA7), *cert. denied*, 385 U.S. 972 (1966), for a helpful description of a physically integrated and centrally dispatched electric power system similar to the MSU system.

ownership and operation of such facilities as are used for the mutual benefit of all the Companies.

Pursuant to the System Agreement, the MSU operating companies share in the costs of the designated participation units and related extra high voltage transmission facilities according to their individual system load responsibilities. The balancing of generating costs occurs under Service Schedule MSS-1 "Capability Equalization," while the balancing of transmission costs is achieved under Service Schedule MSS-2 "Transmission Equalization." Thus, operating companies that own less generating or transmission capability than their existing load responsibilities would otherwise require (termed "short" or "buying" companies) must pay a capacity or transmission equalization charge to the operating companies that own more generating or transmission capability than needed to serve their customers (termed "long" or "selling" companies).

These tariffs are designed to operate as a short term cost equalization mechanism so that "long" companies, and therefore their ratepayers, are compensated by the "short" pool members for supplying power from large scale units to meet the "short" companies' needs. However, once the "long" company's load growth absorbs the total capacity of its plant the entire benefit of economies of scale goes to that company and its customers. Typically such load growth matches the installed capacity in less than four years, and shortly thereafter the once "long" company will become a "short" or buying company.

By filing certain rate revisions to Service Schedules MSS-1 and MSS-2, the MSU operating companies have sought to place operation, maintenance, and general and administrative expenses under the automatic adjustment formulae, thereby making all costs (except cost of equity

which remains fixed) subject to both increases and decreases. Such a tariff is called a full cost of service tariff.

SUMMARY OF ARGUMENT

Far from presenting "an important regulatory issue arising in the special context of federal preemption of state regulatory alternatives," petition at 10, this case raises the routine question whether there was substantial evidence to support the decision of the FERC in a wholesale electric rate case.

The court of appeals applied the correct standard of review to the FERC decision and gave appropriate deference to the FERC's expert judgment in approving a ratemaking method or formula. On the merits, its decision is consistent with those of other courts of appeals that have considered similar questions.

When the FERC approved the full cost of service tariff in this case its action was consistent with federal law, with its past practice and with its stated criteria for granting approval to such tariffs. The Congress has expressly recognized the power of the FERC to approve formula rates. Far from being unjust or unreasonable such rates assure that the seller gets that which he is entitled to and no more, and that the consumers receive rate relief at the time cost decreases are experienced. That the FERC has approved a rate which Louisiana does not like is a straightforward matter for review under the substantial evidence test.

The decision of the court of appeals is correct and does not conflict with the decisions of this Court or the decisions of any other court of appeals. Moreover it does not depart from the accepted and usual course of judicial proceedings, and does not present a question of federal law that requires decision by this Court.

ARGUMENT

a. The court of appeals correctly identified and applied the appropriate standard of review:

> A litigant seeking to overturn a rate decision of FERC must make a "convincing showing that it is invalid because it is unjust and unreasonable under the circumstances." *FPC* v. *Hope Natural Gas Company*, 320 U.S. 591, 64 S.Ct. 281, 288, 88 L. Ed. 333 (1944); *United Gas Pipe Line* v. *FERC*, 618 F.2d 1127, 1131 (5th Cir. 1980). In reviewing a decision by FERC, this Court is "without authority to set aside any rate selected by the Commission which is within a 'zone of reasonableness.'" *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 88 S.Ct. 1344, 1360, 20 L.Ed.2d 312 (1968) (quoting *FPC* v. *Natural Gas Pipeline Company*, 315 U.S. 575, 62 S.Ct. 736, 743, 86 L.Ed. 1037 (1942). Additionally, FERC is not "bound to a single rate making method or formula, but is free to make pragmatic adjustments in it's methods." *Arkansas Louisiana Gas Co.* v. *FERC*, 654 F.2d 435 (5th Cir. 1981). Moreover, in reviewing the facts relied upon by FERC in reaching its decision, this Court must only decide whether the facts relied upon by FERC are supported by substantial evidence. 16 U.S.C. § 825*l*(b) (1976); *In re Permian Basin Area Rate Cases*, 88 S.Ct. at 1372.

Appendix, A-27; 688 F.2d 357, 359-60 (CA5, 1982). The court of appeals found ample support in the past practice of the FERC and congressional recognition thereof in Section 208 of the Public Utility Regulatory Policies Act of 1978, 16 U.S.C. § 824d(f), for the use of an automatic adjustment formula to operate as a rate.

With respect to past practice of the FERC, the court of appeals noted that in *Central Power and Light Co.*, 11 FERC ¶ 61,102 (1980), the FERC decided that the use of automatic adjustment clauses in full cost of service tariffs was appropriate for unit sales and sales to affiliates, and

that the usual notice requirement of Section 205 of the Federal Power Act, 15 U.S.C. § 824d, should be waived for good cause in such cases. The court of appeals was persuaded by the FERC's reasoning that such rates were just and reasonable because they allow both upward and downward adjustments and assure ratepayers of only paying for actual increases and decreases in costs, and because the sales in this case are between affiliates operating on a pool basis.[6] The court of appeals also noted the FERC's reliance on routine FERC audits to discover any possible inaccuracies and, finding substantial evidence to support the FERC's decision that good cause existed in this case to waive the usual notice requirements of Section 205, affirmed FERC's expert judgment that a full cost of service tariff was appropriate, just and reasonable for the Middle South System.

In response to petitioner's argument that such tariffs were either against the law or against strong federal policy, the court of appeals found to the contrary that they were expressly permitted by federal statute, 16 U.S.C. § 824d(f), and had been discussed by the House and Senate conferees who, in the Conference Report, expressly did "not indicate any preference for inclusion or exclusion of any item in an automatic adjustment clause." H.R. Rep. No. 95-1750, 95th Cong., 2d Sess. 96, *reprinted in* 1978 U.S. Code Cong. & Admin. News 7659,

[6] The practical effect of the System Agreement is to allocate the costs incurred within the MSU System to those consumers who have received the benefits of comprehensive power pooling. The System Agreement cannot be used to improve the net earnings of the MSU System, which is consolidated, because a debit to one affiliated company works an automatic credit to the other. Accordingly the effect of any automatic adjustment under the cost of service tariffs in this case is zero on the companies as a whole.

7830, (quoted by the court of appeals at Appendix, A-28, 688 F.2d at 360). Recognizing that the FERC's order was "the product of expert judgment which carries a presumption of validity . . ." (quoting *FPC* v. *Hope Natural Gas, supra*), the court of appeals affirmed the decision to use the automatic adjustment clause. Appendix, A-28, 688 F.2d at 360.

b. The FERC's approval of a full cost of service tariff in this case represents no new or novel departure from its past practice or sound regulatory policy.

The FERC uses two distinct methodologies in electric utility rate setting. The first and more common approach produces a fixed charge based on a company's estimated cost of service. The second adopts what is called a formula, or cost of service, rate into which changing levels of costs are automatically entered to produce the service charge. One or the other of these two methodologies is used depending on the nature of the sale.[7]

A cost of service tariff, which is the kind of rate approved by the FERC in this case, simply passes

[7] When an electric utility agrees to sell electricity, it may contract to sell the electricity from a designated generating resource or, alternatively, from the total amount of electricity that it has from all of its sources. The more common arrangement is the latter, *i.e.*, a general system sale, and typically the rate is fixed at a level based on estimated costs. This fixed charge is necessarily based on estimated costs because it is so difficult to track in a timely manner the enormous number of variables in the recorded costs on a system-wide basis. Lacking a more precise method, utilities and regulators rely on predetermined, fixed rates based on the utility's average costs for service during a designated "test" period, usually 12 months. In contrast to general system sales, when the sale is made from a designated generation unit it is quite possible to achieve better, *i.e.* more accurate, ratemaking through the use of a formula rate that results in a cost of service tariff.

through the actual costs as they are incurred by the designated generation unit and are recorded on the utility's books of account. The utility's books, of course, are subject to routine periodic audits by both state and federal regulators. As noted by the court below, under this methodology the formula itself, rather than an estimated charge, constitutes the utility's filed rate. Appendix, A-30; 688 F.2d at 361. *Accord, Public Service Company of New Hampshire* v. *FERC*, 600 F.2d 944, 947-48 (CA D.C.), *cert. denied*, 444 U.S. 990 (1979). As the costs change, either upward or downward, they are automatically factored into the formula to calculate the unit charge for service without the need for additional filings before the FERC. As long as the formula tracks any decreases as well as increases, the FERC has concluded that it can be assured the company will collect no more than its actual cost of doing business. Furthermore, the FERC has decided that such full cost of service tariffs are appropriate for use in rate making for sales from specifically designated units ("unit sales"), for sales between affiliated companies, and for power pool transactions. *Central Power & Light Co., supra.*

Those courts that have considered formula rate clauses, such as a fuel adjustment clause,[8] have recognized that there is no statutory impediment to having a formula operate as the filed rate, and that there need be no filing with the FERC to reflect fluctuations in costs provided the changes were calculated in accordance with the formula. *Public Service Company of New Hampshire*

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[8] The theoretical justification underlying this form of rate design does not depend on whether the formula tracks only a few costs such as fuel or taxes (as was the case before MSS filed to amend the rate in this proceeding) or nearly all costs (excluding cost of capital, which is more judgmental) as in a full cost of service tariff such as approved by the FERC in this case.

v. *FERC*, *supra*, 600 F.2d at 947.[9] And without exception the courts have held that approval of an electric utility's choice between fixed and formula rates, or types of formula rates, is a matter for the FERC. *Id.* at 959.

To be contrasted with a cost of service formula, which requires both upward and downward adjustments based on recorded cost experience, is an escalator clause. The latter typically raises the price of the service at fixed intervals by a predetermined amount (the escalator) regardless of whether such an increase is otherwise justifiable, or whether the resulting rate in any way matches the increase (or decrease) in costs. Escalator clauses have generally been disapproved. *See, e.g.*, *Episcopal Theological Seminary* v. *FPC*, 269 F.2d 228, 234 (CA D.C.), *cert. denied*, 361 U.S. 895 (1959) (Natural Gas Act); *Sunray Mid-Continental Oil Co.* v. *FPC*, 364 U.S. 137, 153 (1960) (dictum under the Natural Gas Act).

This distinction between escalator clauses and formula rates or cost of service tariffs has routinely been drawn by the FERC: escalator clauses do not necessarily match rate increases to actual cost increases, whereas cost of service tariffs match rates and costs with considerable precision.[10] It is this distinction that petitioner misses when it insists that the present case marks a radical departure from past law and practice.

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[9] *Accord*, Jersey Central Power and Light Co. v. FERC, 589 F.2d 142 (CA3, 1978), *cert. denied*, 444 U.S. 880 (1979); Virginia Electric and Power Co. v. FERC, 580 F.2d 710 (CA4, 1978); Maine Public Service Company v. FPC, 579 F.2d 659 (CA1, 1978).

[10] Indeed, at least one court has suggested that, in the interest of accurate cost recovery, perhaps the FERC should "permit only cost of service tariffs," Public Service Company of New Hampshire v. FERC, *supra*, 600 F.2d at 959.

Petitioner's assertion that the rationale offered by the FERC to justify cost of service tariffs for sales to affiliates is inadequate rests on a misunderstanding of the FERC's reasoning. In this case the cost of service tariff is appropriate under each of the FERC's usual justifications: first, the transactions under the tariff involve sales from designated generation units (those that belong to the "long" companies); designated unit sales offer the clearest example of an appropriate occasion for a cost of service tariff because costs directly attributable to that unit may be identified. Second, because both the buying and the selling companies covered by the tariff are affiliates (in this case wholly owned subsidiaries of MSU, the parent holding company) there is no incentive for undercharging or overcharing; similarly there is no incentive to correct mistaken estimates upon which a fixed charge rate necessarily rests. Indeed, in the case of affiliate sales the FERC has long insisted on the use of cost of service tariffs to ensure that cost decreases, as well as increases, are passed on to the consumers.[11] As additional insurance against unjust or unreasonable rates, the FERC requires that formula rates be expressly considered and explicitly approved as the filed rate (as opposed to being casually accepted as part of a contract filed by the utility with the FERC) before any changes under the clause can be put into effect as exceptions to the notice and review provisions of the Federal Power Act. *Central Power & Light Co.*, *supra* (distinguishing *Sunray Mid-Continental Oil Co.* v. *FPC*, *supra*). Against these clear justifications and safeguards petitioner repeats its speculations about

[11] American Louisiana Pipe Line Co. and Michigan Wisconsin Pipe Line Co., 29 FPC 932, 935-36 (1963), *rev'd and remanded on other grounds*, American Louisiana Pipe Line Co. v. FPC, 344 F.2d 525 (CA D.C., 1965).

imprudently incurred costs. These have already been offered both to the FERC and to the court of appeals.

c. Petitioner suggests (petition at 22-25) that "federalism concerns" and state preemption cases require Supreme Court review of this case. It may be true that the Louisiana Public Service Commission does not approve of the result reached by the FERC; but such disapproval at most reflects nothing more serious than the inevitable tension between two sovereigns in our federal-state dual system of government. While such tensions must be treated respectfully, and have been so treated below, the Supremacy Clause dictates the outcome in this case. In any event, petitioner's threat that "state commissions may have good reason to test the limits of the preemption doctrine by disallowing or adjusting the expenses," petition at 24, will be more appropriately dealt with, should the occasion ever arise, by the lower federal courts in the first instance; it presents no new or novel question for this Court. *See New England Power Co.* v. *New Hampshire*, 445 U.S. 331, 340-43 (1982), and cases therein cited.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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Dated: February 14, 1983

APPENDIX

The full text of Section 313(b) of the Federal Power Act, 16 U.S.C. § 825*l*(b), follows:

(b) Any party to a proceeding under this chapter aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the United States Court of Appeals for any circuit wherein the licensee or public utility to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall forthwith be transmitted by the clerk of the court to any member of the Commission and thereupon the Commission shall file with the court the record upon which the order complained of was entered, as provided in section 2112 of Title 28. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonble ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings which, if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or

setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 346 and 347 of Title 28.